

NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.



Congressional Information Service
Washington, D.C.

**BUDGET IMPLICATIONS AND CURRENT TAX RULES
RELATING TO TROUBLED SAVINGS AND LOAN
INSTITUTIONS**

HEARINGS

BEFORE THE

**COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES**

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

FEBRUARY 22; MARCH 9, AND 15, 1989

Serial 101-1

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

97-047

WASHINGTON : 1989

H 781-41

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J.J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
FRANK J. GUARINI, New Jersey
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
ROBERT T. MATSUI, California
BERYL ANTHONY, Jr., Arkansas
RONNIE G. FLIPPO, Alabama
BYRON L. DORGAN, North Dakota
BARBARA B. KENNELLY, Connecticut
BRIAN J. DONNELLY, Massachusetts
WILLIAM J. COYNE, Pennsylvania
MICHAEL A. ANDREWS, Texas
SANDER M. LEVIN, Michigan
JIM MOODY, Wisconsin

BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
DICK SCHULZE, Pennsylvania
BILL GRADISON, Ohio
WILLIAM M. THOMAS, California
RAYMOND J. McGRATH, New York
HANK BROWN, Colorado
ROD CHANDLER, Washington
E. CLAY SHAW, Jr., Florida
DON SUNDQUIST, Tennessee
NANCY L. JOHNSON, Connecticut

ROBERT J. LEONARD, *Chief Counsel and Staff Director*
PHILLIP D. MOSELEY, *Minority Chief of Staff*

CONTENTS

Press releases announcing the hearings.....	Page 2
---	-----------

WITNESSES

U.S. General Accounting Office, Hon. Charles A. Bowshe, Comptroller General of the United States, Richard L. Fogel, Assistant Comptroller General for General Government Programs, and Frederick Wolf, Assistant Comptroller General for Accounting and Financial Management Programs	64
Federal Deposit Insurance Corporation, Hon. L. William Seidman, Chairman ..	107
Federal Home Loan Bank Board, Hon. M. Danny Wall, Chairman, and Larry White and Roger Martin, Board Members.....	161
Congressional Budget Office, James L. Blum, Acting Director	236
National Credit Union Administration Board, Hon. Roger W. Jepsen, Chairman, Robert Fenner, General Counsel, and D. Michael Riley, Director, Office of Examination and Insurance	288
U.S. Department of the Treasury, Hon. Nicholas F. Brady, Secretary of the Treasury.....	434

American Bankers Association, Thomas P. Rideout.....	300
Association of Community Organizations for Reform Now (ACORN), Irma Pernell.....	410
Astoria Federal Savings and Loan Association, Jackson Heights, N.Y., George L. Engelke, Jr.	320
Bacon, Richard L., Sonnenschein Carlin Nath & Rosenthal, Washington, D.C. ..	334
Carron, Andrew S., First Boston Corp., New York, N.Y.	253
Consumer Federation of America, Peggy Miller, Mark N. Cooper	374
Consumers Union, Michelle Meier	402
Cooper, Mark N., Consumer Federation of America.....	374
Engelke, George L., Jr., United States League of Savings Institutions and Astoria Federal Savings and Loan Association, Jackson Heights, N.Y.	320
Eshleman, J. Richard, Landmark Savings Association, Pittsburgh, Pa.....	358
First Boston Corp., New York, N.Y., Andrew S. Carron	253
First Union National Bank of N.C., Charlotte, N.C., Thomas P. Rideout	300
Goldome, Buffalo, N.Y., Maureen Owens.....	310
Kane, Edward J., Reese Professor of Banking and Monetary Economics, Ohio State University	269
Landmark Savings Association, Pittsburgh, Pa., J. Richard Eshleman.....	358
Maisel, Sherman J., School of Business Administration, University of California, Berkeley	261
Meier, Michelle, Consumers Union	402
Miller, Peggy, Consumer Federation of America	374
National Council of Savings Institutions, Maureen Owens, and Martin A. Regalia.....	310
Owens, Maureen, National Council of Savings Institutions and Goldome, Buffalo, N.Y.	310
Paterson, Christopher A., Rockville, Maryland	417
Pernell, Irma, Association of Community Organizations for Reform Now (ACORN)	410
Regalia, Martin A., National Council of Savings Institutions	310

IV

	Page
Rideout, Thomas P., American Bankers Association and First Union National Bank of N.C., Charlotte, N.C.....	300
Secor Bank, Federal Savings Bank, Birmingham, Ala., Edward M. Selfe.....	352
Stanton, Thomas H., Olwine, Connelly, Chase, O'Donnell & Weyher, Washington, D.C.....	344
United States League of Savings Institutions, George L. Engelke, Jr.....	320

SUBMISSIONS FOR THE RECORD

American Bar Association, Section of Taxation, statement.....	478
National Association of Federal Credit Unions, Kenneth L. Robinson, statement and attachment.....	482

**BUDGET IMPLICATIONS AND CURRENT TAX
RULES RELATING TO TROUBLED SAVINGS
AND LOAN INSTITUTIONS**

WEDNESDAY, FEBRUARY 22, 1989

**HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, DC.***

The committee met, pursuant to notice, at 10:19 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearings follow:]

(1)

FOR IMMEDIATE RELEASE
WEDNESDAY, DECEMBER 7, 1988

PRESS RELEASE #32
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE
BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.),
CHAIRMAN, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A SERIES OF HEARINGS ON THE BUDGET IMPLICATIONS
AND CURRENT TAX RULES RELATING TO TROUBLED SAVINGS
AND LOAN INSTITUTIONS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, announced today that the Committee will hold a series of hearings reviewing the Federal budget implications of the current financial condition of savings and loan institutions, and reviewing the current tax rules which provide assistance to these institutions. The first day of hearings will be held on Wednesday, February 22, 1989, beginning at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.

In announcing these hearings, Chairman Rostenkowski stated: "The financial problems of the savings and loan industry have reached critical proportions, and their implications for the Federal budget must be carefully examined. Insufficient attention has been given to these significant issues in the past and thus, the problems have simply gotten worse.

"The Committee on Ways and Means has a clear responsibility to conduct a comprehensive examination of the financial condition of this important industry in which so many Americans have placed their financial trust and confidence. The purpose of these hearings is for the Committee to ascertain the full dimension of the problem, and the structure and appropriateness of any assistance to the industry that may be necessary. In this regard, the Committee will review the current-law tax rules which provide assistance to savings and loan institutions. Some of these rules were revised in the Technical and Miscellaneous Revenue Act of 1988, and will expire on January 1, 1990.

"By reviewing the budget implications of the current savings and loan institution financial crisis, and also reviewing the current assistance provided to these institutions through the tax law, the Congress and the American taxpayer can make an informed judgement regarding the amount and kind of assistance the Federal government should be providing to these institutions."

BACKGROUND:

The record number of thrift failures has severely strained the financial resources of the Federal Savings and Loan Insurance Corporation ("FSLIC"). Despite the FSLIC Recapitalization Act, enacted last year, the problems in the thrift industry may exceed the estimated \$20 to \$30 billion in cash and borrowing authority that the FSLIC will have available for assistance over the next several years. Based on the projections of some experts, additional assistance, totalling as much as \$50 to \$100 billion more than is projected in the CBO baseline, could be needed during the early 1990s. The budgetary impact of such assistance would depend on the specifics of the financing plan.

These hearings will examine the various estimates that have been made, the assumptions behind those estimates and the budgetary treatment of FSLIC operations.

In addition, the Internal Revenue Code contains special rules which provide assistance to financially-troubled savings and loan institutions. These provisions were modified and extended in the Technical and Miscellaneous Revenue Act of 1988. In general, the tax rules provide that (i) gross income of certain savings and loan institutions does not include assistance payments from the FSLIC; (ii) certain FSLIC-assisted acquisitions of financially-troubled thrift institutions may qualify as tax-free reorganizations without regard to continuity of interest requirements, and (iii) further special rules apply to the carryforward of net operating losses, built-in losses, and excess credits of certain thrift institutions undergoing certain ownership changes. In addition, certain losses of the institution existing at the time of the regulatory assistance, interest expense, and certain portfolio losses are reduced by an amount equal to 50 percent of the tax-free FSLIC assistance payments. Similar rules are provided for banks and assistance payments made by the Federal Deposit Insurance Company. These tax law provisions expire on January 1, 1990.

SCOPE OF THE HEARINGS:

It is anticipated that the first day of hearings will consist of testimony from witnesses invited by the Committee, including government policy makers, corporate representatives, tax practitioners, academicians, and other analysts. In addition, the Treasury Department and the Congressional Budget Office is expected to be invited to testify.

Public testimony is invited for additional hearings which will follow. Testimony is requested by the Committee on the following issues:

- 1) The magnitude of the financial difficulties of the savings and loan industry and the costs, structure and appropriateness of any potential Federal assistance;
- 2) The budget and policy implications of the financial difficulties of the savings and loan industry;
- 3) A review of the current tax law provisions which provide special assistance to savings and loan institutions, some of which expire on January 1, 1990.

Specific dates and times for additional hearings will be announced in a subsequent press release.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721] no later than Friday, January 27, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff [(202) 225-1721].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. (See formatting requirements below.) In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

- 3 -

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are requested to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business on the date two weeks after the date of the last hearing on this issue (to be announced in a subsequent press release) to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the beginning of the last day of the hearings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

FOR IMMEDIATE RELEASE
WEDNESDAY, FEBRUARY 8, 1989

PRESS RELEASE #2
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.),
CHAIRMAN, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES AN ADDITIONAL DAY OF HEARINGS ON THE BUDGET
IMPLICATIONS AND CURRENT TAX RULES RELATING TO TROUBLED SAVINGS
AND LOAN INSTITUTIONS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, announced today that the Committee will hold an additional day of hearings on Thursday, March 9, 1989, reviewing the Federal budget implications of the current financial condition of savings and loan institutions, and reviewing the current tax rules which provide assistance to these institutions. The first day of hearings on this topic, as previously announced will be Wednesday, February 22, 1989. On both February 22, and March 9, 1989, the hearings will begin at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.

In announcing the additional date for these hearings, Chairman Rostenkowski stated: "I am pleased to announce an additional day of hearings on this important topic. There have been significant recent developments and proposals with respect to troubled savings and loan institutions, and I anticipate that the Committee hearings will provide a comprehensive review of the current savings and loan financial crisis as well as the assistance provided to these institutions through the tax law."

BACKGROUND:

On December 7, 1989, Chairman Rostenkowski announced that the first day of hearings on issues relating to troubled savings and loan institutions would be held on February 22, 1989. By that press release, individuals and organizations interested in presenting oral testimony were invited to make requests to testify by January 27, 1989. On February 22, 1989, the Committee will take testimony on these issues from witnesses invited by the Committee. On March 9, 1989, those individuals and organizations who made requests to present oral testimony will be heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons who wish to submit written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business on Wednesday, March 23, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the beginning of the last day of the hearings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will ~~not~~ be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman ROSTENKOWSKI. The committee will come to order.

Today, we begin hearings to review the budget implications and current tax rules relating to troubled savings and loan institutions. The committee intends to conduct a comprehensive review of these issues since so many Americans have placed their financial trust and confidence in savings and loan institutions. Our hearings are timely, as the administration is in the process of developing specific legislative proposals to resolve this crisis.

This committee hopes to obtain reliable information regarding how much the Government has already spent through direct outlays and tax benefits assisting these institutions, and the potential costs of proposals to continue this assistance. Through this review, this committee will be in a position to make informed decisions about what additional revenues may be necessary and the best ways to allocate hard-earned taxpayers' dollars to this financial crisis in the future.

In order to gain a full understanding of these issues, the committee will focus on the following three areas: First, we will inquire into the true costs of the Federal Home Loan Bank Board's actions in transferring 75 troubled thrift institutions in December 1988. These so-called December deals raise significant questions regarding the amount of tax benefits granted to the acquiring entities and what return, if any, the Federal Government may have recovered for the benefits. Reduced revenues from these tax breaks may be felt in the budget for several years.

Second, we will focus on those special tax provisions assisting troubled thrift and bank institutions. These special rules allow transfers of tax benefits from a troubled thrift or bank to an acquirer that are not allowed with respect to other corporate taxpayers. In the tax reform debate of 1985 and 1986, this committee in the House decided to repeal these special tax benefits. During the tax reform conference with the Senate, we agreed to retain the special rules until the end of 1988.

Last year, this committee and the House would have allowed the special relief provisions to expire. But in conference with the Senate, we again agreed to extend the provision until the end of 1989 and to include banks in the scope of the relief provisions. We modified some of the benefits, however, and the January 1, 1989, effective date of those modifications was one reason for the flurry of activity by the Bank Board in December of 1988. We need to get to the bottom of this issue to make sure these tax benefits were not abused in those December deals.

At the end of this year, Congress will again be faced with the issue of whether to continue these special relief provisions. These hearings will provide the data and analysis to help us make that decision.

In addition, if the administration believes these special tax rules are important in solving the thrift crisis, then they should propose an extension of the provisions in the administration's legislative proposal now being prepared. I believe that an extension of these provisions should only be considered in the context of an overall plan to assist and govern thrifts and banks. If an extension is not recommended in the official administration proposal, I do not be-

lieve this committee should be required to consider an extension of these special provisions as special legislation at a later date.

The third area that the committee will focus on during these hearings will be the administration proposal to provide assistance to the hundreds of remaining troubled thrift institutions. I applaud the willingness of the administration to face this issue quickly, but I have several questions regarding the substance of this plan and its cost to taxpayers.

We need to know the details of the proposal and the economic assumptions used in determining its impact on the budget. During these hearings, we will explore the proposal in a comprehensive manner, so that we can judge the plan's soundness in light of this committee's joint responsibilities of raising revenue and managing the Nation's debt.

In anticipation of receiving today's testimony, I sent two of our witnesses—Mr. Danny Wall, Chairman of the Bank Board, and Mr. Charles Bowsher, Comptroller General—written questions which will assist the committee in its inquiry. I would like these letters including these questions, placed in the record. Copies of these letters have been made available to each member of the committee.

[The information follows:]

[illegible]

PHILIP B. HOSKIN, UNIVERSITY CO. & DE STAFF

U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

Mr. M. Danny Wall
Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

As you are aware, on February 22, 1989, you are scheduled to testify as part of the Committee on Ways and Means hearings on the budget implications and current tax rules regarding troubled savings and loan institutions. In order to facilitate your testimony and the Committee's consideration of these issues, I request that you provide written answers to the following questions at the time of your testimony.

- What are the revised estimates of the tax benefits of 1988 case resolutions? Please provide these on a deal-by-deal basis. Please also show the actual dollar amount in each year as well as your present value analysis.

2. In choosing the method by which to resolve cases, the FSLIC by statute is required to choose between liquidation and a FSLIC-assisted merger on the basis of whichever is least costly. Does the revenue cost of tax benefits figure into that calculation in every transaction? Please provide documents showing this calculation in each of the December, 1988, case resolutions.

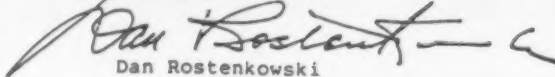
Mr. M. Danny Wall
February 9, 1989
Page Two

3. With respect to question 2, in making this determination, do you assume that the going-concern values have any value in the liquidation?
4. With respect to question 2, has the Board always included tax benefits in its calculations? If not, when did the Board begin to include tax benefits in its calculations?
5. Is the value of net operating losses to the acquiring corporation or entity included in your analysis of tax benefits? If not, please provide a detailed explanation for not taking these items in account. If so, please provide documents showing this calculation in each of the December, 1988, case resolutions.
6. How does the Board negotiate with potential purchasers regarding potential tax benefits in a transaction? Please provide a specific case analysis referring to the so-called "Southwest" transactions of December, 1988.
7. In the period preceding the passage of the Technical and Miscellaneous Revenue Act of 1988, representatives and staff of the Board argued that without extension of special reorganization rules for financially-troubled thrift institutions, the Board would have to resolve more cases through liquidation instead of assisted reorganization. If the special rules were not in place, how many of the FSLIC-assisted mergers which took place in 1988 would have been liquidations?
8. With respect to question 7, what are the basic steps in the typical liquidation?
9. Many commentators believe that managers of FSLIC-assisted thrift institutions that result from FSLIC-assisted mergers do not have adequate incentives to maximize returns of covered assets and, thereby, minimize the cost to the FSLIC. Is this true? Please provide us with provisions in representative contracts that ensure that managers will minimize FSLIC's cost.
10. With respect to question 9, what types of incentives are most common?

Mr. M. Danry Wall
February 9, 1989
Page Three

I look forward to receiving your testimony and working with you as a solution to these important issues is formulated. Thank you for your consideration of these issues.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Dan Rostenkowski", followed by a horizontal line and a small flourish.

Dan Rostenkowski
Chairman

DR:d1c

[ANSWERS TO THE QUESTIONS IN THIS LETTER WERE ANSWERED IN THE TESTIMONY OF THE FEDERAL HOME LOAN BANK BOARD.]

ONE HUNDRED FIRST CONGRESS
 DAN ROSTENKOWSKI, ILLINOIS, (—ARMAN)
 SAM M. GIBBONS, FLORIDA
 J.J. PICKLE, TEXAS
 CHARLES B. RANGEL, NEW YORK
 FORTNEY PETE STARK, CALIFORNIA
 ANDY JACOBS, JR., INDIANA
 HAROLD FORD, TENNESSEE
 ED JEROME, GEORGIA
 RICHARD A. GEPHARDT, MISSOURI
 THOMAS J. DOWNNEY, NEW YORK
 FRANK J. GUARINI, NEW JERSEY
 MARTY RUSSO, ILLINOIS
 DON J. PEASE, OHIO
 ROBERT T. MATSUI, CALIFORNIA
 BERTY ANTHONY, JR., ARIZONA
 RONNIE G. FLIPPO, ALABAMA
 BYRON L. DORGAN, NORTH DAKOTA
 BARBARA D. KENNELLY, CONNECTICUT
 BRIAN J. DONNELLY, MASSACHUSETTS
 WILLIAM J. COYNE, PENNSYLVANIA
 MICHAEL A. ANDREWS, TEXAS
 SANDER M. LEVIN, MICHIGAN
 JIM MOODY, WISCONSIN

ROBERT J. LEONARD, CHIEF COUNSEL AND STAFF DIRECTOR

PHILIP D. MOSELEY, MINORITY CHIEF OF STAFF

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES
 WASHINGTON, DC 20515

February 9, 1989

The Honorable Charles A. Bowsher
 Comptroller General of the United States
 U.S. General Accounting Office
 441 G Street, N.W.
 Washington, D.C. 20548

Dear Mr. Bowsher:

As you are aware, on February 22, 1989, you have been asked and are scheduled to testify as part of the Committee on Ways and Means hearings on the budget implications and current tax rules regarding troubled savings and loan institutions. In order to assist the Committee's consideration of these issues, I request that you provide written answers to the following questions at the time of your testimony, along with other testimony you wish to present to the Committee.

1. With respect to the December, 1988, case resolutions of the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC), those agencies have initially estimated that the present value of tax benefits transferred in those transactions amounts to \$4 billion, and for all of 1988 amounted to \$5.3 billion.

What is your estimate of the tax benefits of the 1988 case resolutions? To the extent possible, please provide these figures on a deal-by-deal basis, showing actual dollar amounts as well as any present-value analysis you may utilize.

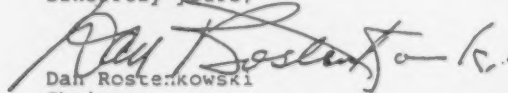
2. In choosing the method to resolve cases, the FSLIC by statute is required to choose between liquidation and a FSLIC-assisted merger on the basis of whichever is least costly. Do the FHLBB and the FSLIC adequately take into account the tax benefits of transactions in making this calculation? Please give us your overall evaluation along with some specific examples from the December, 1988, case resolutions.

Mr. Charles A. Bowsher
February 9, 1989
Page Two

3. Do the FHLBB and the FSLIC correctly analyze and value net operating losses when negotiating the resolution of a troubled thrift? Please give us your overall evaluation along with some specific examples from the December, 1988, case resolutions.
4. Do you think the procedures utilized by the FHLBB and the FSLIC in negotiating the resolution of a troubled thrift adequately account for the potential tax benefits which may result from a transaction?
5. Representatives of the FHLBB have argued that without the special reorganization rules for financially-troubled thrift institutions, the FHLBB would have to resolve more cases through liquidation instead of assisted reorganization. If the special rules had not been in place, how many of the FSLIC-assisted mergers which took place in 1988 do you think would have been liquidations?
6. With respect to the recent Administration proposal on assistance for troubled thrift institutions, I understand that, to date, specific legislative proposals have not been provided to implement the plan. Based upon the information available to you, do you agree with the initial assumptions of amounts which will be required to be paid from general revenues to finance the program?
7. Do you think long-term borrowings can be made at the rates assumed in the Administration proposal to implement the program?
8. In your opinion, what are the financial strengths and weaknesses of the Administration's proposal?

I look forward to receiving your testimony and working with you as a solution to these important issues is formulated. Thank you for your consideration of these issues.

Sincerely yours,


Dan Rostenkowski
Chairman

DR:d1c

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

March 29, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives



Dear Mr. Chairman:

This letter is in response to your February 9, 1989 letter requesting that we provide written answers or relevant testimony regarding questions about FSLIC's December 1988 deals and the Administration's proposal for resolving the FSLIC crisis. We believe our enclosed testimony before the Senate Committee on Banking, Housing and Urban Affairs on FSLIC's 1988 deals, and our recent letter to Representative Paul Kanjorski about the Administration's plan will answer your questions.

Should you have any further questions or need additional information please feel free to contact Stephen Swaim on 452-2833.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Craig A. Simmons".

Craig A. Simmons
Director
Financial Institutions and
Markets Issues

Enclosures

Enclosure I

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

G9-0088

MAR 24 1989

The Honorable Paul F. Kanjorski
House of Representatives

Dear Mr. Kanjorski:

Your letter of February 8, 1989, asks three questions regarding the financial aspects of the Administration's plan (the plan) for resolving problems in the thrift industry and in the deposit insurance system. The questions concern the viability and sufficiency of the plan and the impact of premium changes on commercial banks and savings institutions.

For background purposes, we have prepared a summary of the financial characteristics of the plan. This is contained in enclosure I. Our specific responses to each of your questions are contained in enclosures II, III, and IV. Our discussion draws on our recent report, Troubled Financial Institutions: Solutions to the Thrift Industry Problem,¹ together with other work on the industry condition, the Federal Savings and Loan Insurance Corporation's (FSLIC) case resolution activities, and the finances of both FSLIC and the Federal Deposit Insurance Corporation (FDIC).

Under the plan, most of the new money needed to pay for the FSLIC rescue is slated to come from the Treasury and from the sale of \$50 billion in 30-year bonds by an off-budget financing entity. The Administration estimates that about \$77 billion in Treasury appropriations will be needed through 1999 to help pay for past actions, new cases, a new reserve for healthy thrifts, and financing costs. The plan requires thrift institutions to pay approximately what they are paying now: regular assessment plus the special assessment that has been in effect since 1985. Although premiums charged to FDIC-insured banks increase by almost 80 percent under the plan, these funds are used entirely to restore FDIC's reserves to an adequate ratio in relation to insured deposits.

Our work suggests that the plan, together with the oversight board and other reforms that would be instituted, provides a reasonable framework for solving the thrift industry problem.

¹GAO/GGD-89-47, February 21, 1989.

G9-0088

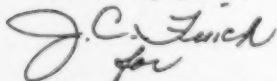
However, the plan rests on several optimistic assumptions regarding such factors as interest rates and the outlook for the economy, and the quality of the assets in cases that have already been acted on or that will be acted on in the next few years. We think the plan's costs are, therefore, likely to be somewhat higher than those currently forecast, and estimate that the amount needed could turn out to be higher than that contemplated in the plan.

Several aspects of the plan's financial arrangements differ from recommendations we made in our February report. For example, we believe all aspects of the plan should be fully reflected in the budget. Other points that we believe should be reviewed carefully are the plan's caps on FDIC notes, sources of liquidity borrowing for resolving cases, and the moratorium on switches from FSLIC to FDIC that would be continued for 5 years under the plan. However, the items mentioned in this paragraph do not represent threats to the plan's viability.

We believe the premium levels contained in the plan, which also narrow the differential between the premiums paid by banks and thrifts, do not represent a significant obstacle to the achievement of capital adequacy requirements. However, if premiums were to be raised much further in the next few years, the tradeoff between deposit insurance financing and achieving capital adequacy goals could become more of an issue.

If we can be of further assistance, please feel free to contact Craig Simmons on 275-8678.

Sincerely yours,

Handwritten signature of J.C. Fitch in cursive script.

Richard L. Fogel
Assistant Comptroller General

Enclosures

Enclosure I

SUMMARY OF THE PLAN'S FINANCIAL CHARACTERISTICS

Discussion about the financial characteristics of the plan is complicated by the variety of assumptions that must be made, including the time period under consideration. Furthermore, different concepts of cost can be used -- present value cost of insurance losses, net budget outlays, total cash needed, or additional cash needed over and above the amounts currently available under existing law.

This summary concentrates on cash needs for the period 1989 through 1999 as set forth in the plan. We think this focus provides the best insight into the nature of the financial aspects of the proposed FSLIC rescue. We discuss both total cash needs and the cash needed over and above that already expected to be available to FSLIC.

USES OF FUNDS

For the period 1989 through 1999, the Administration estimates that a total of \$198 billion will be needed to pay FSLIC's bills and restore the thrift deposit insurance system to financial health. The funds needed are shown in table I.1 and summarized in chart I.1. Of the \$198 billion, \$145 billion is for basic program costs and \$53 billion is for financing costs.

The amount needed for basic program costs is divided as follows:

- \$62.2 billion for administrative expenses, repayment of the secondary reserve, and expenses associated with cases already acted on by the end of calendar year 1988.
- \$50 billion for resolving about 500 presently identified problem cases¹ through the operations of a newly established Resolution Trust Corporation (RTC), a corporation with an Oversight Board and a 5 year life that would contract with FDIC (and perhaps other public or private sector entities) for management support.²

¹The cases involve about 350 GAAP insolvent institutions and another 150 institutions that have no tangible net worth. (Tangible net worth is calculated by removing intangible assets such as good will from GAAP financial statements.) As of September 30, 1988, these 500 institutions held over \$265 billion in assets and had a tangible net worth deficit of about \$18 billion.

²The RTC Oversight Board, which is the board of directors of the corporation, consists of the Secretary of the Treasury, who serves as chairman, the Chairman of the Board of Governors of the Federal Reserve System, and the Attorney General. The

-- \$32.8 billion for insurance losses and reserves for a new Savings Associations Insurance Fund (SAIF) established for all thrift institutions that would not be placed in the RTC. The plan anticipates that \$24 billion will be used to resolve cases after 1992, and \$8.8 billion will be used to build up the SAIF reserves.³

The financing costs under the plan are associated with 30-year bonds issued to help finance the resolution of the remaining thrift cases. Under the plan \$53 billion will be needed by 1999 for (1) interest on the \$10.8 billion in off-budget bonds that would be issued by the Financing Corporation (FICO) pursuant to the recapitalization provisions of the Competitive Equality Banking Act of 1987 (CEBA); (2) interest on \$50 billion in off-budget bonds that would be issued by the Resolution Funding Corporation (REFCORP) for use in funding RTC operations; and (3) purchase of zero coupon bonds to defease the principal of the REFCORP bonds.⁴

SOURCES OF FUNDS

The money needed to pay for insurance operations is derived from several sources. These sources are shown in table I.2 and summarized in chart I.2. Of the \$198 billion that will be required to implement the plan, about \$66 billion is expected to be available from thrift insurance premiums,⁵ FICO bond sales,

proposed legislation regarding RTC states that, in accordance with an agreement between FDIC and the Oversight Board, FDIC shall be the primary manager of RTC. However, the Oversight Board also would hire its own chief executive officer and other staff and would enter into competitive bid contracts on a case-by-case basis.

³If improved supervision or other developments reduce insurance losses after 1992, lower SAIF insurance losses translate directly into higher SAIF reserves until the reserve reaches a 1999 level of about \$24 billion (1.25 percent of insured deposits).

⁴Interest costs for FICO and REFCORP bonds will continue until the year 2020 and 2021 respectively. Total interest costs from 1989 until these bonds mature are estimated to be about \$144 billion.

⁵The basic premium for thrifts and for commercial banks is 8.3 basis points per \$100 of deposits, but since 1985 thrifts have been paying a special premium of an additional 12.5 basis points, bringing their total premium to 20.8 basis points. The Chairman of the FHLBB has stated the special premium will have to remain in effect for at least 30 years. In 1991, the plan increases the assessment for thrifts from the current 20.8 basis points to 23.0 basis points. The rate then drops to 18.0 basis points in 1994

receivership income, and miscellaneous income. This leaves a shortfall of about \$132 billion.

To help obtain the additional money needed, the plan raises about \$5 billion from the Federal Home Loan Banks. However, most of the funding comes from two other sources: \$50 billion in bonds sold to the public by REFCORP, and \$77 billion in appropriations from the Treasury. Proceeds from the sale of REFCORP bonds are used to pay for resolutions of RTC cases. Treasury appropriations are used to (1) pay some of the costs associated with cases resolved by FSLIC in 1988 (\$38 billion); (2) pay most of the interest on the REFCORP bonds (\$22 billion); and (3) contribute to building up SAIF's reserve and resolution costs after 1992 (\$17 billion).

In the event plan expenses exceed \$198 billion or other sources of revenue do not materialize as expected, additional Treasury amounts are authorized to make up any shortfall. Additional authorization from Congress would, however, be required for REFCORP to sell more than \$50 billion in bonds.

OTHER SUMMARY INFORMATION

To show how the elements of the plan fit together, we have prepared several tables. Table I.3 shows the source of funding for each of the major plan components. Table I.4 shows the use made of each source of revenue. In addition, table I.5 shows the relationship between the plan sources and uses of funds we have discussed and the treatment of the plan in the federal budget.

The Congressional Budget Office (CBO) estimates that under the Administration's assumptions the plan will cost \$205 billion through 1999. There are two major differences between this \$205 billion estimate and the administration's \$198 billion estimate. First, CBO does not count the \$8.8 billion for the SAIF reserve because this money will be invested in government securities and will not result in an outlay to the public. CBO does include \$16 billion in additional financing costs to account for interest that the Treasury will have to pay on the debt it will issue to obtain cash. The rationale for including additional interest cost is that any Treasury appropriation as large as \$77 billion over the next 10 years will require borrowing and result in a net increase in the deficit.

and thereafter. Over the period from 1989 through 1999, the net effect of the premium structure imposed by the plan is to reduce premiums collected from thrifts by \$1.6 billion compared to continuation of the 20.8 basis point premium for the entire period.

Table 1.1:
Cash Needed to Pay FSLIC Bills and Establish the
Thrift Deposit Insurance System On a
Sound Financial Basis
\$ Billions

USES OF CASH	FY89	FY90	FY91	FY92	FY93	FY94	FY89-94	FY89-99
BASIC PROGRAM COSTS:								
ADMIN AND MISC EXPENSE	0.3	0.3	0.3	0.3	0.3	0.2	1.7	2.8
SECONDARY RESERVE CREDIT	0.1	0.1	0.1	0.1	0.3		0.7	0.7
TOTAL OLD FSLIC CASES	8.0	6.2	5.2	5.1	5.5	3.6	33.6	58.7
ASSISTANCE PAYMENTS	(5.2)	(4.4)	(3.8)	(4.2)	(3.4)	(2.9)	(23.9)	(28.8)
PRINCIPAL ON NOTES	(0.4)	(0.3)	(0.3)		(1.3)		(2.3)	(19.7)
INTEREST ON NOTES	(1.4)	(1.5)	(1.1)	(0.9)	(0.8)	(0.7)	(6.4)	(9.2)
LIQUIDATIONS	(1.0)						(1.0)	(1.0)
RTC CASES	10.0	25.0	15.0				50.0	50.0
NEW SAIF FUND	0.0	0.0	2.0	3.4	4.7	3.1	13.2	32.8
POST-RTC CASES			(2.0)	(2.4)	(3.6)	(2.0)	(10.0)	(24.0)
ADDITIONS TO RESERVES (a)				(1.0)	(1.1)	(1.1)	(3.2)	(8.8)
SUBTOTAL BASIC PROGRAM COSTS	18.4	31.6	22.6	8.9	10.8	6.9	99.2	145.0
FINANCING COSTS:								
INTEREST ON FICO BONDS (b)	0.6	0.9	1.0	1.0	1.0	1.0	5.5	10.7
INTEREST ON REFCORP BONDS (c)	0.5	1.9	3.4	3.8	3.8	3.8	17.2	36.4
DEFEASANCE-REFCORP BOND PRIN	0.8	2.8	2.5	0.0	0.0	0.0	6.1	6.1
SUBTOTAL FINANCING COSTS (d)	1.9	5.6	6.9	4.8	4.8	4.8	28.8	53.2
TOTAL USES OF CASH	20.3	37.2	29.5	13.7	15.6	11.7	128.0	198.2

SOURCE: Statement of Nicholas F. Brady, February 22, 1989

a The additions to reserves represent an expense associated with establishing a new S&L fund, but do not represent an outlay of cash by the government.

b These are 30-year bonds that mature between FY2017 and FY2020. The assumed interest rate is about 10%. We estimate that the interest expense on the bonds from FY2000 - FY2020 could be an additional \$18 billion. Thus, the total interest expense on the FICO bonds will be about \$29 billion.

c These are 30-year bonds that mature between FY2019 and FY2021. The assumed interest rate is about 7.7%. CMB estimates that the interest expense on the bonds from FY2000 - FY2021 could be an additional \$79 billion. Thus, the total interest expense on the REFCORP bonds will be \$115 billion.

d The financing costs represented in this table do not include any costs associated with an increase in Treasury borrowing to finance the appropriations that could be required to fund FSLIC/RTC/SAIF and interest on REFCORP bonds. CBO has estimated that interest on Treasury borrowing will be \$16 billion over the FY1989 - FY1999 period.

Figure 1.1: Uses of Cash 1989 - 1999

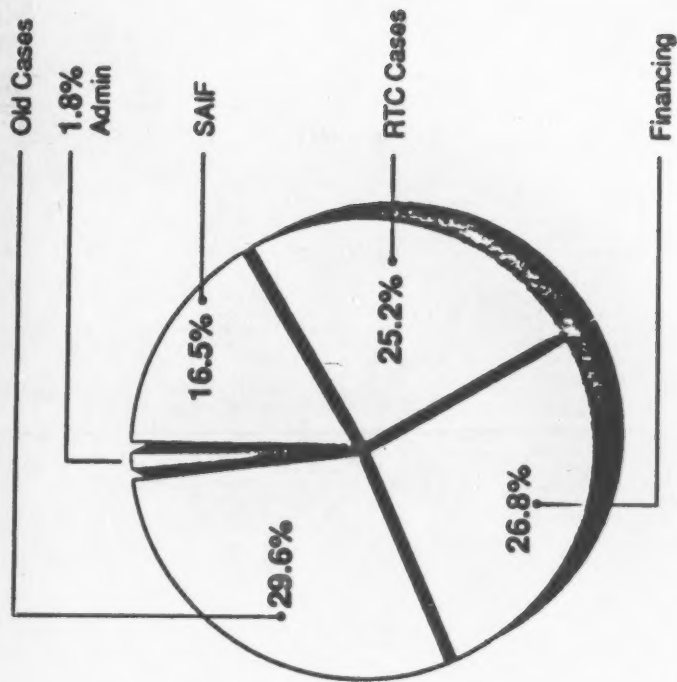


Table 1.2:
Source of Cash For Meeting the Deposit Insurance
Needs for the Thrift Industry, 1989 - 1999
\$ Billions

SOURCES OF CASH	FY89	FY90	FY91	FY92	FY93	FY94	FY89-94	FY89-99
S&L PREMIUMS (a,b)	2.1	2.3	2.7	2.9	3.1	2.6	15.7	31.6
INSURANCE FUND OPERATIONS	3.2	2.4	3.4	3.9	4.5	4.4	21.8	27.7
FSLIC RECEIVERSHIPS	(1.4)	(1.4)	(1.2)	(1.0)	(1.4)	(1.5)	(7.9)	(9.7)
OTHER FSLIC COLLECTIONS	(0.4)	(0.4)	(0.4)	(0.3)	(0.3)	(0.4)	(2.2)	(3.5)
INCOME ON INVESTMENTS	(0.1)				(0.1)	(0.1)	(0.3)	(1.1)
DECREASE IN EXISTING CASH	(1.3)	(0.1)					(1.4)	(1.4)
NET RECEIVERSHIPS		(0.5)	(1.8)	(2.6)	(2.7)	(2.4)	(10.0)	(12.0)
BORROWING	13.8	28.3	15.0	0.0	0.0	0.0	57.1	57.1
NEW REFCORP PROCEEDS	(10.0)	(25.0)	(15.0)				(50.0)	(50.0)
FICO PROCEEDS	(3.8)	(3.3)					(7.1)	(7.1)
PROCEEDS FROM FHLB	0.8	1.1	0.8	0.3	0.3	0.3	3.6	5.1
TREASURY APPROPRIATIONS	0.4	3.1	7.6	6.6	7.7	4.4	29.8	76.7
TOTAL SOURCES OF CASH	20.3	37.2	29.5	13.7	15.6	11.7	128.0	198.2

SOURCE: Statement of Nicholas F. Brady, February 22, 1989

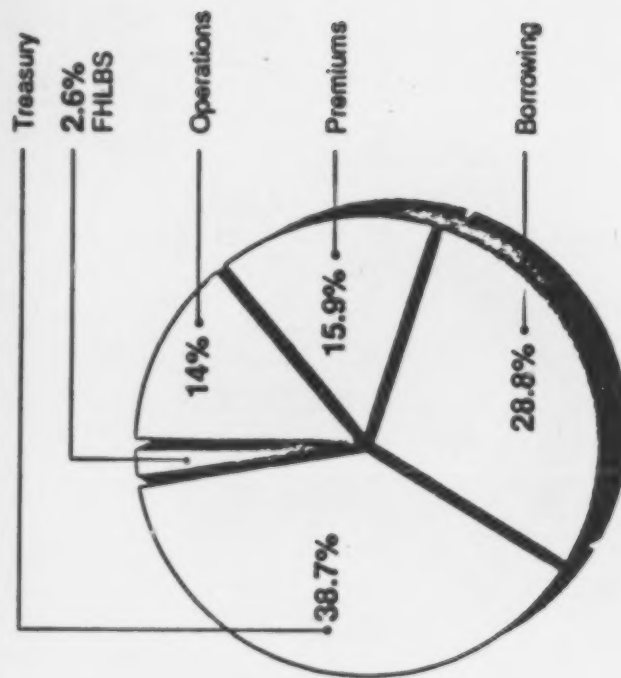
a At the present time, thrift institutions are paying premiums at the rate of 20.8 basis points per \$100 of deposits. This consists of a regular premium of 8.3 basis points, plus a special premium of 12.5 basis points that was instituted in 1985. The Chairman of the FHLBB has said that it will be necessary to continue the special premium for at least 30 years.

Under the plan, the S&L assessments are based on a premium rate of 20.8 basis points until December 31, 1990; 23 basis points from January 1, 1991 through December 31, 1993; and 18 basis points January 1, 1994, and thereafter. Assuming that deposits grow at 7.2% annually, the plan will have the following effect on the gross premium revenue that would have been available under current legislation:

FY89	FY90	FY91	FY92	FY93	FY94	FY89-94	FY89-99
0.0	0.0	+0.3	+0.3	+0.4	-0.3	+0.7	-1.6

b Interest expense on FICO bonds, the secondary reserve credit, and defeasance for the new REFCORP bonds actually represent a claim against the premium revenue stream from the thrift industry. For this table, these items have not been deducted from the premium revenue to demonstrate the entire income stream that would be available if the premiums were not encumbered by these claims.

Figure 1.2 Sources of Cash 1989 - 1999



Source: Table 1.2

Table 1.3:
Uses of Cash to Meet the Deposit Insurance
Needs for the Thrift Industry by Source, 1989 - 1999
\$Billion

USES OF CASH BY SOURCE	FY89	FY90	FY91	FY92	FY93	FY94	FY89-94	FY89-99
BASIC PROGRAMS:								
FSLIC ADMIN & OLD CASES	0.3	6.5	5.5	5.4	5.8	3.8	35.3	61.5
S&L PREMIUMS	(1.4)	(-0.4)	(-0.1)				(0.9)	(0.9)
FSLIC OPERATIONS	(3.2)	(1.9)	(1.6)	(1.3)	(1.8)	(2.0)	(11.8)	(15.7)
FICO BONDS	(3.8)	(3.3)					(7.1)	(7.1)
TREASURY APPROPRIATIONS	(-0.1)	(1.7)	(4.0)	(4.1)	(4.0)	(1.8)	(15.5)	(37.8)
SECONDARY RESERVE CREDIT	0.1	0.1	0.1	0.1	0.3		0.7	0.7
S&L PREMIUMS	(0.1)	(0.1)	(0.1)	(0.1)	(0.3)		(0.7)	(0.7)
RTC CASES	10.0	25.0	15.0				50.0	50.0
REFCORP BONDS	(10.0)	(25.0)	(15.0)				(50.0)	(50.0)
SAIF	0.0	0.0	2.0	3.4	4.7	3.1	13.2	32.8
S&L PREMIUMS				(1.8)	(1.8)	(1.6)	(5.2)	(15.9)
TREASURY APPROPRIATIONS			(2.0)	(1.6)	(2.9)	(1.5)	(8.0)	(16.9)
SUBTOTAL BASIC PROGRAMS	18.4	31.6	22.6	8.9	10.8	6.9	99.2	145.0
FINANCING:								
INTEREST ON FICO BONDS [a]	0.6	0.9	1.0	1.0	1.0	1.0	5.5	10.7
S&L PREMIUMS	(0.6)	(0.9)	(1.0)	(1.0)	(1.0)	(1.0)	(5.5)	(10.7)
INTEREST ON REFCORP BONDS [b]	0.5	1.9	3.4	3.8	3.8	3.8	17.2	36.4
TREASURY	(0.5)	(1.4)	(1.6)	(0.9)	(0.8)	(1.1)	(6.3)	(22.0)
FHLB INCOME				(0.3)	(0.3)	(0.3)	(0.9)	(2.4)
RECEIVERSHIP PROCEEDS		(0.5)	(1.8)	(2.6)	(2.7)	(2.4)	(10.0)	(12.0)
DEFEASANCE-REFCORP BOND PRIN	0.8	2.8	2.5	0	0	0	6.1	6.1
S&L PREMIUMS		(1.7)	(1.7)				(3.4)	(3.4)
FHLB RETAINED EARNINGS [c]	(0.8)	(1.1)	(0.8)				(2.7)	(2.7)
SUBTOTAL FINANCING [d]	1.9	5.6	6.9	4.8	4.8	4.8	28.8	53.2
TOTAL USES OF CASH	20.3	37.2	29.5	13.7	15.6	11.7	128.0	198.2

SOURCE: Statement of Nicholas F. Brady, February 22, 1989

a These are 30-year bonds that mature between FY2017 and FY2020. The assumed interest rate is about 10%. We estimate that the interest expense on the bonds from FY2000 - FY2020 could be an additional \$18 billion. Thus, the total interest expense on the FICO bonds will be about \$29 billion.

b These are 30-year bonds that mature between FY2019 and FY2021. The assumed interest rate is about 7.7%. OMB estimates that the interest expense on the bonds from FY2000 - FY2021 could be an additional \$79 billion. Thus, the total interest expense on the REFCORP bonds will be \$115 billion.

c The FHLBanks will contribute about \$1 billion to defease the \$10.8 billion principal for the FICO bonds (not included in these tables). The \$2.7 billion that the FHLBanks will contribute to the principal on the REFCORP bonds represents the \$2 billion of the FHLBanks' retained earnings which are allocated to but not needed by FICO; plus about 20% of their annual earnings, or \$300 million, in FY89, FY90, and FY91.

d The financing costs represented in this table do not include any costs associated with an increase in Treasury borrowing to finance the appropriations that could be required to fund FSLIC/RTC/SAIF and interest on REFCORP bonds. CBO has estimated that interest on Treasury borrowing will be \$16 billion over the FY1989 - FY1999 period.

Table I.4:
Source of Cash and How It is Used to Meet the
Deposit Insurance Needs For the
Thrift Industry, 1989 - 1999
\$ Billions

SOURCES OF CASH AND HOW IT IS USED	FY89	FY90	FY91	FY92	FY93	FY94	FY89-94	FY89-99
S&L PREMIUMS (a,b)	2.1	2.3	2.7	2.9	3.1	2.6	15.7	31.6
FICO INTEREST	(0.6)	(0.9)	(1.0)	(1.0)	(1.0)	(1.0)	(5.5)	(10.7)
SEC RESERVE CREDIT	(0.1)	(0.1)	(0.1)	(0.1)	(0.3)		(0.7)	(0.7)
DEFEASE NEW BONDS		(1.7)	(1.7)				(3.4)	(3.4)
FSLIC RESOLUTION FUND	(1.4)	(-0.4)	(-0.1)				(0.9)	(0.9)
SAIF				(1.0)	(1.0)	(1.6)	(5.2)	(15.9)
INSURANCE FUND OPERATIONS	3.2	2.4	3.4	3.9	4.5	4.4	21.8	27.7
OLD FSLIC CASES	(2.9)	(1.6)	(1.3)	(1.0)	(1.5)	(1.8)	(10.1)	(12.9)
ADMIN AND MISC EXPENSE	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.2)	(1.7)	(2.8)
INTEREST ON REFCORP BONDS		(0.5)	(1.8)	(2.6)	(2.7)	(2.4)	(10.0)	(12.0)
BORROWING	13.8	28.3	15.0				57.1	57.1
RTC CASES	(10.0)	(25.0)	(15.0)				(50.0)	(50.0)
OLD FSLIC CASES	(3.8)	(3.3)					(7.1)	(7.1)
PROCEEDS FROM FHLB	0.8	1.1	0.8	0.3	0.3	0.3	3.6	5.1
DEFEASE REFCORP BOND PRIN [c]	(0.8)	(1.1)	(0.8)				(2.7)	(2.7)
INTEREST ON REFCORP BONDS				(0.3)	(0.3)	(0.3)	(0.9)	(2.4)
TREASURY APPROPRIATIONS	0.4	3.1	7.6	6.6	7.7	4.4	29.8	76.7
POST-RTC CASES			(2.0)	(0.6)	(1.8)	(0.4)	(4.8)	(8.1)
INTEREST ON REFCORP BONDS	(0.5)	(1.4)	(1.6)	(0.9)	(0.8)	(1.1)	(6.3)	(22.0)
ADDITIONS TO RESERVES				(1.0)	(1.1)	(1.1)	(3.2)	(8.8)
FSLIC - OLD CASES	(-0.1)	(1.7)	(4.0)	(4.1)	(4.0)	(1.8)	(15.5)	(37.8)
TOTAL SOURCES OF CASH	20.3	37.2	29.5	13.7	15.6	11.7	128.0	198.2

SOURCE: Statement of Nicholas F. Brady, February 22, 1989

a At the present time, thrift institutions are paying premiums at the rate of 20.8 basis points per \$100 of deposits. This consists of a regular premium of 8.3 basis points, plus a special premium of 12.5 basis points that was instituted in 1985. The Chairman of the FHLBB has said that it will be necessary to continue the special premium for at least 30 years.

Under the plan, the S&L assessments are based on a premium rate of 20.8 basis points until December 31, 1990; 23 basis points from January 1, 1991 through December 31, 1993; and 18 basis points January 1, 1994, and thereafter. Assuming that deposits grow at 7.2% annually, the plan will have the following effect on the gross premium revenue that would have been available under current legislation:

FY89	FY90	FY91	FY92	FY93	FY94	FY89-94	FY89-99
0.0	0.0	+0.3	+0.3	+0.4	-0.3	+0.7	-1.6

b Interest expense on FICO bonds, the secondary reserve credit, and defeasance for the new REFCORP bonds actually represent a claim against the premium revenue stream from the thrift industry. For this table, these items have been treated as a separate use of cash to demonstrate the full cost of old FSLIC cases, the total defeasance for the new REFCORP bonds, and the entire income stream that would be available if the premiums were not encumbered by these claims.

c The FHLBanks will contribute about \$1 billion to defease the \$10.8 billion principal for the FICO bonds (not included in these tables). The \$2.7 billion that the FHLBanks will contribute to the principal on the REFCORP bonds represents the \$2 billion of the FHLBanks' retained earnings which are allocated to but not needed by FICO; plus about 20% of their annual earnings, or \$300 million, in FY89, FY90, and FY91.

Table I.3
Budget Impact of Meeting the Deposit Insurance
Needs of the Thrift Industry, 1989 - 1999
\$ Billions

	FY89	FY90	FY91	FY92	FY93	FY94	FY89-94	FY89-99
TOTAL CASH REQUIRED	20.3	37.2	29.5	13.7	15.6	11.7	128.0	198.2
deduct:								
CASH FROM NON-FEDERAL SOURCES	14.6	29.4	15.8	0.3	0.3	0.3	60.7	62.2
PROCEEDS FROM FHLB	(0.8)	(1.1)	(0.8)	(0.3)	(0.3)	(0.3)	(3.6)	(5.1)
BORROWING	(13.8)	(28.3)	(15.0)				(57.1)	(57.1)
INSURANCE FUND REVENUES	5.3	4.7	6.1	6.8	7.6	7.0	37.5	59.3
S&L PREMIUMS	(2.1)	(2.3)	(2.7)	(2.9)	(3.1)	(2.6)	(15.7)	(31.6)
INSURANCE FUND OPERATIONS	(3.2)	(2.4)	(3.4)	(3.9)	(4.5)	(4.4)	(21.8)	(27.7)
TOTAL TREASURY APPROPRIATIONS	0.4	3.1	7.6	6.6	7.7	4.4	29.8	76.7
deduct:								
NOTES ISSUED BEFORE FY89	0.4	0.3	0.1	0.0	1.1	0.0	1.9	19.2
INCREASE IN RESERVES	0.0	0.0	0.0	1.0	1.1	1.1	3.2	8.0
add:								
NOTES ISSUED AFTER FY87	9.7	0.0	0.0	0.0	0.0	0.0	9.7	9.7
DECREASE IN CASH	1.3	0.1	0.0	0.0	0.0	0.0	1.4	1.4
BUDGET OUTLAYS FOR THRIFT DEPOSIT INSURANCE ACTIVITIES	11.0	2.9	7.5	5.6	5.5	3.3	35.8	59.8
deduct:								
NEW FDIC COLLECTIONS	0.0	0.8	1.6	1.7	1.8	1.9	7.8	19.9
NET BUDGET OUTLAYS FOR DEPOSIT INSURANCE ACTIVITIES	11.0	2.1	5.9	3.9	3.7	1.4	28.0	39.9

SOURCE: Statement of Nicholas F. Brady, February 22, 1989

Enclosure II

1. IS THE PRESIDENT'S PLAN FINANCIALLY VIABLE? HOW MUCH MONEY WILL BE RAISED BY EACH PART OF THE PLAN, AND ARE THE YEAR-BY-YEAR SUMS AND TOTAL SUM SUFFICIENT TO MEET YOUR COST ESTIMATE OF OUR NEEDS?

Because of the many assumptions that must be made, nobody can say exactly how much money will ultimately be needed to pay FSLIC's bills and restore the thrift deposit insurance system to financial health. These assumptions include the condition of thrift institutions, interest rates, the state of the economy, the policies for resolving thrift cases, and the success of regulatory reforms in heading off future failures. A viable plan for financing FSLIC's rescue, therefore, needs these three elements:

- Enough funding to cope with reasonable estimates of the size of the problem.
- Flexibility to increase or decrease funding in the future.
- Adoption of reforms and controls over spending to assure that money is spent wisely and past mistakes are not repeated.

Although we have questions about some of its aspects, we think the plan is viable because it includes each of these essential elements. The discussion which follows compares the plan's estimates with estimates we have made. This is followed by our analysis of cost factors and other aspects of the financial plan.

In the report previously cited and in subsequent testimony we have stressed the importance of making significant reforms a condition for committing large amounts of federal funding to a FSLIC rescue. Without those reforms, the mistakes of the past are likely to be repeated and prove just as costly. The plan's basic structure incorporates this principle. For example, the plan transfers FSLIC's insurance functions to FDIC, increases capital requirements, and gives the deposit insurance agency additional powers to protect the integrity of the deposit insurance funds.

We question, however, whether the reforms go far enough in providing independence to the deposit insurance system and to the supervision of thrift institutions. The plan leaves primary supervisory responsibility for thrifts with the Federal Home Loan Banks, and the Chairman of the reorganized FDIC would serve in that capacity at the pleasure of the President. We believe the Chairman of that agency should have a fixed term as Chairman. At present the Board's public members serve 6-year terms and the Board itself selects the Chairman from among the two public members.

COMPARISON WITH OUR PRIOR ESTIMATES

In our February 21, 1989, report on solutions to the thrift industry problem, we said that Congress should adopt a funding plan that provided at least \$85 billion more than the amount of money FSLIC anticipated receiving from premium income, FICO bonds, and other sources. The money was needed to pay for (1) unfunded costs of the deals used to resolve cases in 1988, (2) resolve the cases of institutions that were already insolvent, (3) resolve the cases of other institutions that may become insolvent, and (4) establish an adequate reserve for the system.

In transmitting our report to Congress, we noted that several factors could serve to increase our \$85 billion. For example, we pointed out that costs could increase if interest rates go up further, a recession occurs, or the condition of thinly capitalized, but solvent, institutions deteriorates. Rather than trying to make new estimates based on these factors, we said it would be best to undertake such an analysis when the details of the Administration's plan were available.

The amounts contained in the plan generally exceed the minimum estimate contained in our report. The most significant difference between the plan and our earlier estimate involves financing costs. Our \$85 billion estimate did not include payment of interest on long-term bonds because the use of such financing was but one of the financing alternatives that could be used. If 30-year bonds are used to pay for case resolution expenses, a substantial interest component should be included in the cost.

OBSERVATIONS ON THE PLAN'S COST ASSUMPTIONS

All in all, we believe it would be unrealistic to expect the ultimate costs to the government of the FSLIC rescue to be less than those included in the plan. In particular, there are several factors that could serve to increase the costs.

- Higher interest rates (together with a flat or inverted yield curve) could increase financing costs and create additional losses in insolvent or weak institutions.
- Recession could lead to additional insolvencies.
- Deposits may grow more slowly than the plan assumes, thus lowering premium income.
- The cash needed for the 1988 deals may be higher than estimated.
- The costs to resolve the 500 presently identified problem cases may be higher than the plan assumes.

- The interest spread between Treasury securities and REFCORP bonds of comparable maturities may be higher than the plan assumes.

The following paragraphs discuss some of these factors, including the relatively optimistic assumptions that have been made in some instances. The sensitivity of plan estimates to changes in underlying assumptions can be more easily quantified in some areas than others.

Deposit Growth

One of the assumptions that can be quantified is the deposit growth rate. In estimating revenues from insurance assessments, the plan assumes that S&L deposits will increase by 7.2 percent annually and that bank deposits will increase by 6.9 percent. These increases are fairly consistent with the average annual increase over the last 10 years. However, over the last three years, deposits in S&Ls have increased by an average of 4.8 percent per year (including interest credited to accounts), while bank deposits have increased by an average of about 5.5 percent per year. Furthermore, the level of deposits at the end of December 1988 was actually slightly less than the level in March 1988.

If the rate of growth in FSLIC deposits over the decade averaged 3 percent per year rather than 7.2 percent, an additional Treasury appropriation of about \$7 billion would be needed to fund the plan. It should be noted, however, that some depositors who withdraw funds from S&Ls or choose not to make deposits in them may put their funds in banks, thereby making bank deposits increase by more than 6.9 percent annually. Although bank assessments are not used to resolve the S&L crisis, for budget purposes, any increase in banks' assessments (which would occur if bank deposits increase more than assumed) will offset the budget impact of at least part of any reduction in S&Ls' assessments occurring should deposits in S&Ls decline or increase less than assumed.

Interest Rates

The plan's funding arrangements rest on the optimistic assumption that interest rates will fall rather sharply from their level at the end of 1988. The plan assumes a normal yield curve and a fall in the rate for long-term Treasury issues from

8.8 percent in 1989 to 6.2 percent in 1991.¹ Recently, however, the long-term Treasury rate has risen to over 9 percent and yield curve changes have brought many short-term rates above long-term ones.

Rising interest rates and changes in the yield curve can increase the cost of the plan in a number of ways. Some of those ways can be measured fairly easily. For example, CAO has estimated that the rate for 30-year government bonds will average 2 to 3 full percentage points higher than the rates assumed in the plan. This would result in an increase in interest costs on REFCORP bonds of over \$9 billion for the 1989-1999 period. Higher interest costs would also increase the subsidies built into the deals FSLIC used to resolve cases in 1988, although the interest rate assumptions used in estimating the costs of these deals are higher than the basic assumptions that have been used for the plan as a whole. These higher costs would be partially offset by a \$2 billion reduction in the amount of money needed to purchase zero coupon bonds to defease the principal of the REFCORP bonds.

Higher interest rates and changes in the yield curve also make it more likely that additional thrift institutions will fail. However, this influence is particularly difficult to quantify. The difficulty of making such estimates for thrifts is aggravated by FHLBB's unwillingness to release information it collects each quarter that would provide insight into institutions' exposure to interest rate changes. Recession, too, which many economists think is likely in the next several years, would tend to increase the number of thrifts that fail.

Cost of Deals Made in 1988

In addition to interest rate assumptions, the costs of deals made in 1988 depend on assumptions about the value of problem assets and the rate at which these assets are sold. Acquirers are obligated to undertake detailed audits of problem assets, but it is too early to know what these audits will show. In one instance, however, the preliminary results of an audit show that the FSLIC note to eliminate negative net worth needs to be increased by about two-thirds. (Reduction in the value of assets would also serve to increase future payments under capital loss guarantees.)

Cost estimates for the 1988 transactions are also based on the assumptions that acquiring institutions would sell assets at the same rate as a liquidating receivership run by FSLIC. However, the guaranteed yields on many of the assets acquired in the 1988 transactions appear to provide an incentive for institutions to

¹ A normal yield curve is one in which the rate of interest rises throughout the maturity range.

delay selling those assets. Although FSLIC has some control over when acquiring institutions sell assets, we question how successful FSLIC can be in monitoring acquirers' actions. A 10 percent increase in the cost of past transactions due to the factors discussed here, would increase Treasury's cost over the 1989 to 1999 period by about \$6 billion.

The plan authorizes RTC to review the assistance transactions FSLIC entered into after January 1, 1988. We believe that RTC should be required to review these with the objective of determining what steps could be taken to limit the government's future obligations. For example, promissory notes could be redeemed or assets on which guaranteed yield agreements exist could be purchased. To accomplish this, the plan may need additional funding in the first several years. However, whether any of these actions would make sense financially will depend on the facts of each case.

New Case Resolution Costs

The RTC's need for cash in resolving the cases of the 500 thrifts that are either GAAP insolvent or without tangible net worth could easily go higher than the \$50 billion included in the plan. Based on past experience, it is reasonable to expect RTC involvement to be required in resolving almost all of the 500 cases. Treasury officials point out that on a present value basis, case resolutions in 1988 cost FSLIC an amount approximately equal to the tangible net worth deficit of these institutions plus a little over 8 percent of the institutions' total assets. Applying this formula to the entire current group of 500 cases (which, as of September 30, 1988, had a tangible net worth deficit of \$18 billion and assets of \$265 billion) results in an estimate of the present value loss of about \$40 billion in RTC cases.

There is, however, no fixed relationship between the present value cost and the cash that will be needed to resolve cases. In certain types of assisted mergers the two costs will be about the same if the insurance fund can resolve the case by paying the acquiring institution cash for the amount of the economic loss. In liquidations, an up front commitment of cash must be made that exceeds the ultimate present value cost. The cash costs of assisted mergers will also exceed present value costs if notes or guarantees are used as part of the transactions. (For example, in FSLIC's Southwest plan assisted mergers, cash costs are estimated to be about 80 percent greater than present value costs.)

The plan assumes that about half of the problem cases will be resolved by liquidation. The cash requirements of these liquidations would appear to be sufficient to bring the total

cash needed by RTC to over \$50 billion.² Any use of notes or guarantees to resolve merger cases or inability to recover as much as anticipated on assets acquired in liquidations would also push RTC's cash needs up higher. Furthermore, due to continuing operating losses, it is likely that the present value cost of resolving the 500 cases as calculated currently will increase before all of the cases can be acted upon.

Interest on REPCORP Bonds

In calculating the interest on REPCORP bonds, the plan assumes that these bonds will sell in the market at about 30 basis points more than comparable Treasury issues -- a spread about equal to those of regular agency issues such as the obligations of the Federal Home Loan Bank System. FICO bonds, by contrast, have sold up to 100 basis points over Treasury issues however, the spread has been declining. Market reaction to REPCORP bonds, which are not to be guaranteed by the government, will depend upon perception of the overall soundness of the plan and of the certainty of Treasury appropriations for meeting interest payments that are due. We are not in a position to guess the market's reaction. Each 10 basis points above the 30 basis point yield differential assumed in the plan raises interest costs by about \$.5 billion over the 1989-1999 period. If a mechanism is to be established whereby Treasury is authorized to pay any interest that is due on the bonds, we think it would make sense to consider guaranteeing the bonds to obtain the lowest rate possible. Alternatively, the funds could be borrowed directly from the Treasury.³

Conclusion

The preceding discussion demonstrates that some of the plan's assumptions may be on the optimistic side and that Treasury's costs could go higher than the \$77 billion included in the plan. However, if costs do increase, the Administration's plan does provide the flexibility to pay for those expenses through additional Treasury funding. Many of these factors affecting cost are not within the plan's control, although they underscore

²The plan assumes that recoveries on assets sold by liquidating receiverships will total \$12 billion, an amount used to pay part of the interest on REPCORP bonds.

³Direct Treasury borrowing would save a little over \$1 billion in the 1989-1999 period and about \$4.5 billion over 30 years. If Treasury borrowing was authorized, however, a way would have to be devised to obtain \$5 billion from the Federal Home Loan banks to defease the bonds and pay interest.

the importance of being certain that implementation is monitored closely so that the Congress and all other concerned parties are fully aware of whatever developments may occur.

We have not attempted to evaluate the year by year sums that are contained in the financial plan. The amounts that are needed depend on a number of program features that have to be decided, including some of the issues discussed below. We believe that the Office of Management and Budget and the Congressional Budget Office are in the best position to determine the year by year funding requirements and their impact on budget totals.

GAO ANALYSIS OF OTHER ISSUES THAT
HAVE A BEARING ON THE PLAN'S FINANCES

This section discusses several issues that have a bearing on the financial characteristics of the plan. These issues, some of which relate to recommendations in our February 21 report, are:

- Caps on FDIC notes.
- Off-budget financing.
- Sources of liquidity.
- Insurance fund switches.

Caps on FDIC Notes.

The plan limits the amount of notes, debentures, or similar obligations, including estimated losses for guarantees or other liabilities, the insurance funds can have outstanding at any one time to 50 percent of the net worth of the respective insurance fund. We support a limit, and recommended last year that such a limit be placed on FSLIC obligations. However, the Administration's proposal may be overly restrictive, as the limit on the Bank Insurance Fund would be a little more than the obligations FDIC currently has outstanding. There can be valid business reasons for issuing notes and other guarantees, and the use of such notes in 1989 could help launch a program that is consistent with budget targets. Also, we need to ensure that FDIC has sufficient flexibility to operate effectively. Therefore, we support a limit closer to the audited net worth of the fund, as suggested by FDIC.

Off-Budget Financing

The plan uses an "off-budget" entity, REPCORP, to raise a portion of the funds needed to resolve the crisis, and uses industry resources to repay the principal on the debt issued. This approach carries some cost to the government since any borrowing by an off-budget entity will be at rates higher than Treasury rates. We previously recommended, and continue to believe, that an on-budget approach should be used, even if it

requires revising the Gramm-Rudman-Hollings deficit targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar enterprises set up to operate on a business-like basis. (See Financial Management Issues, GAO/OCG-89-7TR, November 1988.)

Sources of Liquidity

Our report recommended that FSLIC (or the thrift deposit insurance agency) be authorized to undertake short-term borrowing for liquidity purposes, to enable FSLIC to move as quickly as possible to resolve problem cases. A rapid resolution pace, gives rise to two types of liquidity needs. The first involves maintaining the liquidity of individual insolvent institutions until their cases can be fully resolved. The second involves financing the cash flow associated with the case resolution action.

The recent situation in which FDIC, acting by agreement with the FHLBB, has taken control of a large number of insolvent thrifts underscores the need for an adequate source of liquidity to the deposit insurance system. The Federal Home Loan Bank System and the Federal Reserve have entered into an arrangement for meeting liquidity needs in a situation in which FDIC lacks the money to resolve cases. However, the agreement allows the Federal Reserve System in essence to make loans to insolvent institutions, an action that runs counter to the basic lender of last resort function in which funds are advanced to illiquid but solvent institutions. We believe it would be far preferable to find a way to undertake such short-term borrowing from the Treasury. The proposed legislation would allow FDIC and RTC to each borrow up to \$15 billion from the Treasury, but these limits may be too restrictive to meet all liquidity needs.

Insurance Fund Switching

Our February 21 report recommended allowing healthy thrifts that meet FDIC's qualifying criteria to switch to FDIC upon paying some combination of an exit fee and a capital contribution to FDIC. The plan incorporates this principle, but provides for a 5-year moratorium on switching funds subject to certain exceptions. We understand the desire to attempt to hold a deposit base to finance the new SAIF insurance fund. If a sufficiently large number of healthy thrifts switch to FDIC, the level of thrift deposits will be far below that assumed in the plan.

However, we think there are advantages in allowing thrifts to switch between funds as soon as a plan is adopted. First, it would allow market forces to operate without an artificial regulatory restraint. Over time, as mergers and other activities

occur it is likely to be increasingly difficult to achieve the objective of the moratorium. The principal advantage is probably that as long as costs to healthy thrifts were similar, the desire to switch would represent a market test of the value of a thrift charter and of the strength of thrift institutions' belief in the need for continuation of a specialized housing finance industry. If a sufficiently large number of healthy thrifts migrate to FDIC, adjustments would have to be made in the plan's financial arrangements to assure an appropriate industry contribution for resolving the thrift problem. In this connection it should be noted that very little of the case resolution financing (except for future SAIF cases) would be affected by eliminating the moratorium.

Enclosure III

2. HOW WILL THE PROPOSED INCREASE IN DEPOSIT INSURANCE PREMIUMS FOR COMMERCIAL BANKS AND SAVINGS AND LOANS AFFECT THE ABILITY OF THESE INSTITUTIONS TO RAISE FUNDS TO MEET THE NEW CAPITAL REQUIREMENTS?

Under rules that have been adopted by commercial bank regulators and FHLBB, many institutions face the prospect of having to raise their capital as a percentage of assets. They can do this by attracting new capital, by increasing retained earnings, or by shrinking -- i.e., reducing assets and liabilities by corresponding amounts.

The premium charges for commercial banks and savings institutions that are contained in the plan should not significantly affect the ability of these institutions to meet their capital requirements. Most of the additional money required for resolving the thrift crisis comes from the Treasury and from borrowing. Although an increase of about 10 percent in thrift premiums is contemplated for the 3 years 1991 through 1993, the premium drops below the existing level after that. Overall, the amount of money collected from thrifts is less than would occur without passage of the plan. (See table III.1)

Commercial banks will face an increase in the deposit insurance premium of about 80 percent by 1991. (See table III.2) However, their premium will still be below that required of thrifts and the increase in premiums will be used entirely to bring the level of FDIC's reserves back to a ratio of 1.25 percent of insured deposits. Although there is no generally recognized standard for fund adequacy, the 1.25 percent ratio corresponds to the standard of adequacy which the deposit insurance system has used for years.

Table III.1:
Thrift Industry Deposit Insurance
Premiums, 1989-1999^a
 (in \$ billions)

<u>Fiscal Years</u>	<u>Premium rates and amounts paid under present law and FHLBB policy^b</u>		<u>Premium rates and amounts paid under the Administration's plan</u>	
	<u>Rate</u>	<u>Amount^c</u>	<u>Rate</u>	<u>Amount^c</u>
1989	20.8	\$2.1	20.8	\$2.1
1990	20.8	2.3	20.8	2.3
1991	20.8	2.4	23.0	2.7
1992	20.8	2.6	23.0	2.9
1993	20.8	2.7	23.0	3.1
1994	20.8	2.9	18.0	2.6
1995	20.8	3.2	18.0	2.8
1996	20.8	3.4	18.0	2.9
1997	20.8	3.6	18.0	3.2
1998	20.8	3.9	18.0	3.4
1999	20.8	<u>4.1</u>	18.0	<u>3.6</u>
Total		<u>\$33.2</u>		<u>\$31.6</u>

^aAssumes a 7.2 percent growth in deposits each year.

^bAt the present time, thrift institutions are paying premiums at the rate of 20.8 basis points per \$100 of deposits. This consists of a regular premium of 8.3 basis points, plus a special premium of 12.5 basis points that was instituted in 1985. The Chairman of the FHLBB has said that it will be necessary to continue the special premium for at least 30 years.

^cIf the fund reserves exceed 1.25 percent of insured deposits, rebates can be given for part of the premium.

Table III.2:
Commercial Bank Deposit Insurance
Premiums, 1989-1999^a
(in \$ billions)

<u>Fiscal Years</u>	<u>Present law</u>		<u>Administration's plan</u>	
	<u>Rate^b</u>	<u>Amount^c</u>	<u>Rate^b</u>	<u>Amount^c</u>
1989	8.3	\$1.7	8.3	\$1.7
1990	8.3	1.9	12.0	2.7
1991	8.3	2.0	15.0	3.6
1992	8.3	2.1	15.0	3.8
1993	8.3	2.3	15.0	4.1
1994	8.3	2.4	15.0	4.4
1995	8.3	2.6	15.0	4.7
1996	8.3	2.8	15.0	5.0
1997	8.3	3.0	15.0	5.4
1998	8.3	3.2	15.0	5.7
1999	8.3	3.4	15.0	6.1
Total, 1989-1999		\$27.4		\$47.2

^aAssumes a 6.9 percent growth in deposits each year.

^bThe rates are stated in terms of the number of basis points per \$100 in domestic deposits.

^cWhen the fund reserves reach 1.25 percent of insured deposits, rebates can be given for part of the premium. Banks have not received significant rebates since 1983.

In a sense, any payment of deposit insurance premiums can be viewed as taking away from the money an inadequately capitalized institution could use to build up capital. However, this could also be said of the telephone bill or any other item of expense. Deposit insurance is designed as an industry financed insurance arrangement that, until the recent FSLIC problem, was able to meet its obligations entirely from current premiums and reserves built from past surpluses. We see no reason to change this basic feature of deposit insurance, and we support provisions to allow insurance officials to raise premiums (within limits) based on cost experience.

At current premium levels, or those contemplated under the plan, the cost of deposit insurance does not represent a great burden on the industry. Even with the special premium assessment that has been in effect, deposit insurance assessments constitute less than 2 percent of the total operating expenses of thrifts. Also, unlike other items of expense, deposit insurance helps institutions by reducing the amount of capital that market participants would no doubt otherwise require banks and thrifts to hold to protect depositors against loss. If substantial increases in deposit insurance premiums over and above those included in the plan were being sought over the next three or four years, the issue of potential impact on achieving capital adequacy would become more significant. —

Enclosure IV

3. HOW MANY COMMERCIAL BANKS AND SAVINGS AND LOANS WILL BECOME INSOLVENT OR FALL BELOW MINIMUM CAPITAL STANDARDS, AS A RESULT OF THE PROPOSED INCREASE IN DEPOSIT INSURANCE PREMIUMS?

To assess the effect of increased deposit insurance premiums on commercial banks and thrifts, we examined the changes in their financial position on September 30, 1988, under the different premium scenarios. Under the current premium structure there were 432 GAAP-insolvent thrifts and 96 GAAP-insolvent commercial banks at September 30, 1988.

With an increase in the premium rate to \$.23 per \$100 of deposits for the thrift industry, there would have been an additional 20 thrifts insolvent at September 30, 1988, and 32 additional thrifts would have fallen below a 3 percent GAAP net worth level. For commercial banks, the increase to \$.12 per \$100 of deposits, and the subsequent increase to \$.15 per \$100 of deposits would have added three banks to the total number of insolvents and 11 to those with less than 3 percent GAAP net worth.

These results are shown in table IV.1. These numbers were obtained by subtracting the additional costs of the new premiums from the reported net worth of the institutions, and then reclassifying the institutions according to their new net worth categories. It does not follow, however, that the higher premiums would actually have the effects shown here because the institution may be able to make other adjustments in their operations to offset some or all of the premium change.

Table IV.1:

Number of Thrifts by GAAP Net Worth Category
Under Different Premium Rates, September 1988:

	Thrifts		Commercial Banks		
	\$.21/\$100	\$.23/\$100	\$.08/\$11	\$.12/\$100	.15/100
NW < 0%	432	452	96	99	99
NW > 0% & < 3%	401	433	219	226	230
NW > 3%	2,191	2,139	12,941	12,931	12,927

Source: FHLBB Quarterly Financial Report

FDIC Quarterly Statement of Condition

Enclosure II

United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:30 a.m.
Tuesday,
March 14, 1989

FAILED THRIFTS: GAO's Analysis of Bank
Board 1988 Deals

Statement of
Charles A. Bowsher
Comptroller General
of the United States

Before the
Committee on Banking, Housing
and Urban Affairs
United States Senate



GAO/T-GGD-89-11

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL
OF THE UNITED STATES

GAO's analysis of Federal Home Loan Bank Board 1988 deals to resolve failed thrifts has intensified GAO's earlier reservations about the appropriateness of the deals.

- The way purchasers for the Texas thrifts were solicited and selected may not have enabled FSLIC to attract the largest pool of qualified prospective acquirers and may not have resulted in the best terms possible.
- The costs to FSLIC will be higher than estimated if the guaranteed assets do not have the projected values or if interest rates increase. Also, the new thrifts lack incentives to most effectively manage and liquidate the guaranteed assets.
- GAO's estimate of the potential tax benefits to the acquirers for the 1988 transactions is between \$7 billion and \$8 billion on a present value basis. This is between about 20 and 40 percent higher than what FSLIC estimated. Moreover, FSLIC did not adequately take these benefits into account when negotiating the agreements. In deciding whether merger or liquidation was least costly, FSLIC was not legally required to consider the cost of the tax benefits. But GAO's analysis suggests that, if the full cost of the deals to the Government is considered, liquidation would have been cheaper in as many as a third of the 12 transactions GAO reviewed.
- Some purchasers will recover their capital investments very quickly because of the tax benefits--in an average of 3 years in 9 of the transactions. The range is from 1 to 5 years. The new thrifts are also thinly capitalized, a situation which has historically provided incentives to take risks.
- GAO questions whether FSLIC presently has the resources for the extensive monitoring these complex deals require.

GAO believes the Government should review the deals to take advantage of provisions to reduce its cost. But this action, which includes buying notes and assets, is dependent on the Government having sufficient funds.

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss the Federal Savings and Loan Insurance Corporation (FSLIC)-assisted sales of failed thrifts approved by the Federal Home Loan Bank Board in 1988. This work was done in response to the October 20, 1988, request from you and five other Senators to select and assess five transactions and your December 30, 1988, request concerning the December 1988 transactions.

During 1988, the Bank Board acted on some 220 thrifts at an estimated present value cost to FSLIC of about \$37 billion. Of this total, 179 thrifts were sold to acquirers in 86 transactions at a present value cost of \$28.4 billion. Seventy-five of the 179 thrifts were sold in 34 transactions in December. We reviewed 12 transactions--5 that occurred before December, the 5 Southwest Plan December transactions, and the 2 largest non-Southwest Plan transactions. Of the 12, 8 were Southwest Plan transactions. (Table 1.)

Our analysis of these transactions has reinforced the views we have expressed previously to your Committee and increased our concerns about the appropriateness of the deals.

-- The costs to FSLIC will be higher than estimated if the guaranteed assets do not have the projected values or if interest rates increase.

- Our estimate of the tax benefits for the 1988 transactions is between \$7 billion and \$8 billion in present value terms-- about 20 to 40 percent higher than FSLIC estimated. FSLIC did not explicitly take these benefits into account, nor were they legally required to, when they chose to merge institutions rather than liquidate them.
- If the full cost of the deals to the federal government is considered, our analysis suggests that liquidation could have been cheaper in as many as a third of the transactions we reviewed.
- It appears that tax benefits will enable some purchasers to recover their capital investments very quickly. For the 12 transactions examined, we estimate the investment in as many as three-fourths can be recaptured in an average of 3 years, ranging between 1 and 5 years.
- The new thrifts are thinly capitalized, a situation which historically provides incentives to take risks.
- There is a lack of sufficient incentives for the new thrifts to effectively manage and liquidate the guaranteed assets to minimize FSLIC assistance costs.

- The selection process was loosely structured and administered inconsistently. The process may have decreased the pool of prospective bidders, inhibited FSLIC's ability to evaluate the acceptability of proposals, and resulted in a less efficient use of FSLIC resources.
- The new thrifts have competitive advantages over unassisted thrifts.
- FSLIC and the Bank Board have included complex control features in the agreements. But we question whether FSLIC can administer these extensive monitoring provisions with present resources.

Based on these points, we believe the deals should be carefully reexamined. The administration's bill authorizes the Resolution Trust Corporation to make such a review. Options that would be used to reduce the government's costs include prepayment of negative net worth notes and purchase of guaranteed assets. Of course, the government's ability to exercise such options depends on the availability of adequate funding.

TRANSACTION COSTS

We are concerned that the costs of the 1988 transactions may exceed the FSLIC estimates--about \$17 billion in present value

terms or about \$62 billion on a cash basis.

-- The financial condition of the failed thrifts is not known.

Initial audits are to be conducted, for example, at the new thrifts in Texas to determine, among other things, the amount of the negative net worth note. While no such audit has yet been approved, we understand that for one thrift the note may be increased by about two-thirds.

-- FSLIC assumed, in making cost estimates for the Texas transactions we examined, that interest rates would only rise 1 to 1 1/2 percent over the 10 year period of the Southwest Plan assistance agreements. If interest rates increase more, the costs to FSLIC will rise.

TAX BENEFITS

The total cost to the government will probably be higher than FSLIC has estimated because of the tax benefits to the acquirers.

Special provisions in the Internal Revenue Code grant substantial tax benefits to acquirers of insolvent thrifts. FSLIC often shares in these benefits. One provision makes the sale of insolvent thrifts eligible for tax-free treatment as a reorganization without meeting all the usual requirements. Qualification as a tax-free reorganization and other special

provisions allow the acquired thrift's preagreement net operating losses (NOLs) to be deducted against the future income of the new thrift.

The rules also enable the new thrift to carry over the full value of assets from the acquired thrift. Because this value is generally higher than the fair market value, there is a loss when the assets are sold. This "built-in" loss is deductible against the new thrift's income and may also be used to offset income of a holding company which owns the thrift.

Other special provisions provide that FSLIC assistance is excluded from taxable income and is not reflected in the tax basis of the new thrift's assets. The principal types of FSLIC assistance payments are: guaranteed returns on assets; interest on FSLIC notes; negative net worth notes; and reimbursements for expenses and built-in losses. The use of these benefits was extended for transactions entered into in calendar year 1989, but reduced by 50 percent.

FSLIC provided us with projections of the tax consequences of the 1988 transactions and the basis on which they made these calculations on February 9, 1989. They showed total tax benefits of \$5.7 billion when calculated in present value terms.

For the 86 transactions resolved in 1988, we estimate the tax

benefits, on a present value basis, to be between \$7 billion and \$8 billion. This is consistent with both Treasury and the Joint Committee on Taxation estimates and is about 20 to 40 percent more than FSLIC estimated.

We estimated that the tax benefits for the 12 transactions on which we focused are over \$5 billion on a present value basis--about 20 percent higher than the \$4 billion plus FSLIC estimated.

Our estimate is different from FSLIC's because we used different assumptions. After discussions with tax experts from Treasury and the Joint Committee on Taxation, we decided to use a different weighted tax rate to reflect our assumption that the tax benefits would offset more income at the normal 34 percent corporate rate rather than at the 20 percent alternative minimum tax rate. We reduced the combined benefits of built-in-losses and income maintenance payments by assigning a tax basis to them as indicated by current IRS administrative practice. Because of tax planning opportunities that are available, we assumed more NOLs will be used.

This is the major reason our estimate is higher than FSLIC's. FSLIC did not consider tax planning but rather relied on their income projections for the new thrifts. We also used a 10-year Treasury rate in calculating the present value of the benefits.

Using these different assumptions for each of the 12 transactions reviewed, we compared the full government cost of the assisted transactions to the FSLIC cost of liquidating the failed thrifts. Our analysis suggests that liquidation could have been less costly for as many as a third of the transactions. FSLIC, however, was not statutorily required to consider tax benefits in deciding whether merger was less expensive than liquidation.

We also estimated the timeframes in which the acquirers' capital¹ could be recovered through tax benefits. In 9 of the 12 transactions, we estimate that the acquirers' tax benefits would equal the capital within an average of 3 years. The range was from 1 to 5 years. Two of the remaining transactions gave all the tax benefits to FSLIC. The other remaining one will not recover the capital through tax benefits during the period studied.

I want to emphasize that determining accurately the tax consequences of these transactions is very difficult. The true market value of failed thrifts' assets, which affects the tax, is not known, nor is the timing of asset sales. The future profitability of the new thrift and any holding company is difficult to estimate. And, it is difficult to anticipate the future business decisions of the new owners in light of the tax

¹Capital, for the purpose of this analysis, does not include subordinated debt.

benefits available.

FHLBB officials have said that the tax benefits of the transactions were treated like any other asset and included in the negotiations. FSLIC did not have sufficient information to undertake an evaluation of tax benefits at the time the transactions were approved. FSLIC did not estimate the tax benefits of its 1988 transactions until January 1989. It seems highly unlikely that FSLIC got full value for these benefits in all the transactions.

The special tax benefits, which now apply to banks as well as thrifts, are used in the resolution of insolvent institutions. The need for the continuation of the special tax provisions depends on the extent to which FSLIC and FDIC are able to resolve failed institutions using insurance funds alone. In this regard, we believe it would be far preferable to take the actions we have recommended² to ensure the financial soundness of the insurance funds so that the insurers have the means to pay for, and thus fully recognize, resolution costs, rather than resorting to using special tax benefits.

²Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GGD-89-47, Feb. 1989).

LACK OF INCENTIVES TO MANAGE ASSETS

The provisions of the agreements may not provide sufficient incentives for acquirers to actively manage and liquidate assets in the least costly manner to FSLIC and the federal government. Certain provisions shield the acquirers from loss on asset sales below book value and provide FSLIC with most of any gain above book value. Other provisions reduce the guaranteed return rate on covered assets over the term of the agreement but also guarantee a cash inflow for specified periods.

While FSLIC usually reimburses the new thrift for any difference between book value and recovery, the thrift can use the amount of the difference as a tax deduction. It is thus to the acquirer's benefit--from a tax perspective--to sell assets at the lowest percentage of book value, thus generating the largest loss. Also, if the acquirer increases the return on a covered asset, the FSLIC tax-free payment is reduced. Any return the asset actually generates is taxable.

Selling assets also reduces the covered asset pool and thus the amount of assets for which yield maintenance is provided. FSLIC attempted to provide incentives for acquirers to manage and dispose of assets most effectively by including gain and loss sharing agreements. All 12 transactions we reviewed included a gain sharing agreement; the provisions varied considerably. Five

transactions included loss sharing agreements.

The yield maintenance guarantees, 10 years for Southwest Plan transactions and one other and 5 years in another one, decline over the period as an incentive to dispose of assets. Two transactions did not include a yield guarantee. Rates for the 8 Southwest Plan transactions ranged from 220 to 275 basis points over the average Texas cost of funds in year 1 to 90 to 200 points in year 10. These rates are meant to provide for operating expenses associated with the assets and profit. FSLIC was unable to estimate how much of the premium would be profit after operating expenses.

There is no certainty that the reductions in guaranteed yield agreements provide enough incentive for acquirers to properly manage and dispose of property. The acquirers' plans to sell an asset could be influenced by several factors, one would be any gain or loss sharing agreement with FSLIC. Another is the amount of profit included in the yield guarantee compared to the expected net profit after tax from reinvesting the proceeds from the sale. A final consideration would be the best timing for the use of tax benefits from the capital loss deductions.

Provisions in the transactions give FSLIC some control over the acquirers' management and disposition of assets. A typical provision obligates the acquirer to use its best efforts to

manage and liquidate assets in a manner that will minimize losses. Also FSLIC may, for example, require an acquirer to sell a covered asset. We have concerns, however, about the enormous monitoring job facing FSLIC and how realistic it is to expect FSLIC to effectively utilize these controls.

SOLICITATION AND SELECTION

The Bank Board and FSLIC operate under very broad statutory guidelines with respect to soliciting and selecting acquirers for insolvent thrifts. The Bank Board's general procedures for marketing insolvent thrifts under its Southwest Plan, implemented in the Federal Home Loan Bank System's Ninth District, differed from procedures used elsewhere.

For example, most investors were asked to submit initial proposals without knowing which thrifts were being marketed, how FSLIC planned to combine them in groups, or the thrifts' current financial condition. This "blind" process, along with FSLIC's practice of combining less desirable insolvent thrifts in packages with those for which there was more interest, may have (1) decreased the likelihood of attracting the largest pool of qualified prospective bidders, (2) inhibited FSLIC's ability to evaluate the acceptability of proposals it did receive, and (3) resulted in a less efficient use of FSLIC's limited resources.

To enhance the probability of success, the plan targeted potential acquirers before the bidding process formally began. Then, FSLIC solicited proposals from interested thrift and nonthrift investors, including the targeted acquirers already identified and investors who had submitted proposals for, or expressed interest in purchasing Texas thrifts.

A few FSLIC officials, assisted by district bank staff and under the Bank Board's guidance, evaluated the proposals that were received on the basis of how well they met the Plan's objectives and decided whether each was acceptable under the Plan. These officials also decided which package of thrifts was best suited for each acceptable investor. The investors considered acceptable for a specific package were then told the identities of the thrifts in that package and requested to submit a detailed proposal. The bidders were not allowed to visit the subject thrifts or review their accounts. After detailed proposals were received, FHLBB staff and private contractors representing FSLIC negotiated the final terms of the transactions.

One of the primary problems with the Southwest plan process was the lack of knowledge about the condition of the thrifts and the continuing efforts of FSLIC officials putting together the deals to "mix and match" insolvent thrifts to match the apparent capacity of acquirers to put up capital and manage thrifts. The process was very fluid. And in several cases bidders became

insolvent and became part of the packages.

There was no typical transaction. In one Southwest Plan transaction, the Plan had identified a particular thrift as a targeted acquirer for one of the packages of thrifts. The FSLIC official who led the early negotiations said that thrift was told the identity of the thrifts in the package as part of the process of identifying targeted acquirers. Subsequently that thrift and 14 other bidders expressed interest in one or more of the insolvent thrifts in the package in response to FSLIC's request for proposals. The targeted thrift contacted by FSLIC was the only one which bid on all thrifts in the package. After reviewing the 15 bids, FSLIC and district bank staff selected that thrift as the one with which to begin negotiations.

Negotiations began in May 1988. The acquiring thrift's proposal would have left the new thrift with RAP capital of 1.5 percent. By July, FSLIC discovered the acquiring thrift was having trouble with its own solvency, and required it to raise additional capital to complete the transaction.

The thrift contacted a private investor which agreed to provide the needed capital. However, before completing the transaction, the investor hired an audit firm to evaluate the acquiring thrift's accounts. The audit and a district bank examination revealed the acquiring thrift's assets had been substantially

overvalued and, in fact, the thrift was later found to be insolvent.

PSLIC ended negotiations with that thrift and placed it in the package of thrifts to be merged. PSLIC then added additional thrifts from another package to this package and started negotiating with the investor for the whole package of thrifts. The new package was not rebid to anyone else. The deal was then completed.

In contrast, a different process was used in one deal we reviewed that was not a part of the Southwest Plan. In this transaction, PSLIC asked 239 potential investors from its National Marketing List to attend a marketing conference if they were interested in bidding on certain insolvent thrifts with a certain asset size. The 25 investors who attended the conference were provided specific financial and other data on the thrifts. The bidders were allowed to review the accounts of the insolvent thrifts, a process called due diligence. Three proposals were received and cost estimates were made for each one. One was rejected because it exceeded the cost of liquidation. Negotiations started with the low cost bidder but broke down when that bidder could not obtain the financing needed for its proposal. Negotiations then started with the other bidder and finalized the deal.

COMPETITIVE ADVANTAGE

The assisted thrifts have certain financial advantages and protections that unassisted depository institutions do not. The advantages stem from the relatively low level of acquirer capital, the FSLIC assistance and guarantees, forbearances, and the tax savings.

As we have stated previously, the capital provided by acquirers is low in relation to the size of the thrift and this has historically created incentives to take risks.³

Having FSLIC assistance means the acquirer can count on some income for up to 10 years, regardless of what happens in the economy or thrift industry. For the 8 Southwest Plan transactions we reviewed, FSLIC estimates show its assistance makes up from about 50 to over 80 percent of projected gross income within the first five years.

Thrifts are now required to have a regulatory capital/liability ratio of 3 percent, rising to 6 percent at a rate tied to profitability in the industry. The 12 transactions resulted in 15 new thrifts. Financial information as of December 31, 1988, was available for 14. Capital to total liabilities ratios in 7

³Failed Thrifts: Bank Board's 1988 Texas Resolution (GGD-89-59, Mar. 1989).

of the 14 was below 3 percent.

FSLIC also provides forbearances from other requirements, such as transactions with affiliates in the holding company.

Forbearances shield the thrift from supervisory actions, and also let them undertake activities normally allowed for fully capitalized thrifts only. The FHLBB states that thrift supervisors have various controls over these forbearances.

Another advantage is that the new thrifts in Texas can use not only the FSLIC note to collateralize advances from the Federal Home Loan District Bank but also estimated future payments from FSLIC as collateral.

MONITORING MECHANISMS

Because of the complex nature of the transactions, FSLIC will have to monitor the assisted thrifts for lengthy periods of time. We question whether FSLIC has the resources to do this well.

One safeguard in most transactions is the provision in an agreement that FSLIC may take control of the new thrift if its regulatory capital drops to a certain level--often between 1 and 2 percent. Also, FSLIC may limit the payment of dividend under certain circumstances.

The complex agreements present a huge monitoring job for both FSLIC and Bank Board examiners and supervisors. The assistance agreements include a large number of controls. For example, FSLIC must approve: asset schedules, asset summaries; asset plans for large assets; asset budget summaries; asset sales requests; and asset term sheets if the thrift is providing the financing. For the 5 pre-December transactions we reviewed, there are over 87,000 covered assets with a book value of \$7.1 billion. The 3 pre-December 1988 Southwest Plan thrifts had 552 large (over \$5 million or \$6 million) assets, each requiring a detailed asset plan.

Thrifts are also required to submit litigation schedules and reports; FSLIC must approve plans and budgets for significant litigation. (FSLIC reimburses the thrift for these expenses). FSLIC must also review reports showing the tax benefits of the transaction in the prior year; FSLIC can assess if it is receiving the percentage of the benefit agreed upon. FSLIC also reviews itemized charges for yield maintenance and capital loss payments submitted quarterly for payment. For Southwest Plan transactions, the new thrifts are required to submit three different consolidation plans for approval.

We have asked FSLIC for information on the pre-December transactions concerning the number of plans or reports submitted by thrifts, whether they were submitted on schedule, and how many

FSLIC has approved or denied. We also have asked for summary information on the monitoring requirements for the December transactions. FSLIC does not maintain such information centrally and was still in the process of obtaining it from the assisted thrifts for us as we were preparing this testimony.

VIABILITY OF NEW THRIFTS

WAS CONSIDERED

The viability of the new thrifts is important to FSLIC because it insures the deposits of those thrifts and has an equity stake in most of them. FSLIC generally assessed the viability of the new entities before the transactions were approved. FSLIC's analyses showed that 9 out of 10 of the new thrifts we reviewed would be profitable, including the FSLIC assistance as income, within the first 5 years. (FSLIC had not done a viability analysis for thrifts in two of the transactions.)

We found, however, that FSLIC had not reduced the assistance income to the thrifts by the amount of the tax benefits they were required to return to FSLIC. Such reductions in income would affect both profitability and the regulatory capital levels projected, as FSLIC usually assumed all income will be retained. The implication of excluding tax benefits is that some of these new thrifts may not be viable without additional infusion of capital.

- - - - -

The administration's bill authorizes the Resolution Trust Corporation to review and analyze these transactions, including all means by which costs can be reduced. We think this review should be required.

That concludes my prepared statement. My colleagues and I will be pleased to answer any questions.

Table 1:
INFORMATION ON 12 DEALS
(FSLIC - Supplied Data)
(millions)

TRANSACTION NAME (AND NUMBER OF THIRTS)	ACQUIRED ASSETS	ACQUIRED LIABIL- ITIES	FSLIC ESTIMATED COST (CASH)		FSLIC ESTIMATED COST (PRESENT VALUE)		ACQUIRER CONTRIBU- TION	TAX BENEFIT TO FSLIC
			MERGER	LIQUIDA- TION	MERGER	LIQUIDA- TION		
SOUTHWEST PLAN								
Southwest Savings (4)	\$3,998	\$4,990	\$3,521	\$1,844	\$1,980	\$2,502	\$25.0 ^a	100 ^b
Gibson (12)	2,217	3,193	2,379	1,166	1,314	1,546	48.0	100 ^b
McOlney (11)	3,750	4,300	2,293	1,041	1,287	1,468	80.0	60 ^c
CFEB (15)	1,831	3,236	3,378	1,814	1,846	2,117	120.0	27 ^b
Utley/Ford (5)	12,006	13,026	8,908	6,281	5,046	6,822	315.0	28 ^c
Pacific (8)	854	1,151	987	530	566	662	37.5	25 ^d
Centex (4)	323	649	813	417	429	464	26.5 ^d	42 ^e
Hyperion (1)	4,400	4,700	2,200	1,111	1,372	1,492	200.0	42 ^f
NEW SOUTHWEST PLAN								
D. P. Holdings (1)	954	1,407	696	600	566	700	20.0	0 ^g
River Valley (3)	170	188	36	34	36	45	5.0	6 ^h
First Nationwide ^g (4)	8,086	8,373	3,108	1,734	1,684	2,431	175.0	73 ⁱ
Base (1)	30,000	Not Available	Not Calculated		1,700	3,333	500.0	75 ^j

^a The acquirer did not contribute new capital. About \$25 million in subordinated debt was converted to common stock.

^b FSLIC is entitled to 33-1/3% of all tax benefits realized but is guaranteed minimum tax benefits of \$11.1 m (NPV).

^c FSLIC is entitled to 33-1/3% of all tax benefits realized calculated at a 30% tax rate. Assistance payments are tax effected on this basis but FSLIC is guaranteed a minimum of \$10 m each year of the Agreement.

^d \$3.5 m of the \$26.5 capital contribution represents the historical value of real estate.

^e Negative Net Worth Note was reduced by \$13.2 m as a prepayment of the estimated tax benefits due FSLIC for 1988; this amount is subject to adjustment after tax return is filed.

^f Resulting entity will not generate sufficient taxable income to take advantage of most of the tax benefit items.

^g Incorporating the asset backed transfer on December 9.

Source: FSLIC reported unaudited data.

Chairman ROSTENKOWSKI. We begin these hearings by taking testimony from several Government policymakers and industry experts invited by the committee to testify. On March 9, the committee will continue taking testimony, hearing from industry executives and other experts. In addition, on that date, Treasury Secretary Brady will present the administration's testimony as well as an explanation of President Bush's budget for fiscal year 1990.

In this regard, I plan to send Secretary Brady a letter setting forth questions regarding the administration's savings and loan assistance proposal, which I would like him to answer in his testimony. I will make a copy of that letter available to the members of this committee.

Today, we will begin with testimony from Charles Bowsher, Comptroller General of the United States. Mr. Bowsher, it is a pleasure to have you with us today. My staff has explained to me that you have a schedule that is quite tight, and I hope that we can proceed and allow you to finish in adequate time. But before you begin your testimony, I am going to yield to my colleague, Mr. Vander Jagt.

Mr. VANDER JAGT. Thank you very much, Mr. Chairman. I am pleased that we are having these hearings on the budgetary impact of the savings and loan crisis, with special emphasis on how the tax rules add or subtract from the taxpayers' burden. There are widely differing assessments of the budgetary implications of the problem and of the administration proposal to resolve them. I hope that these hearings will give us a clearer picture of what the budgetary impact is.

Like you, Mr. Chairman, I am concerned about the flurry of activity at the end of the year by FSLIC to complete thrift financial transactions, and I hope that we will be able to take a look at just how much of a tax burden was accumulated by this; and whether the Federal Government got their money's worth out of it; and how much incentive or disincentive those tax benefits provided in terms of efficient management in the future.

Since, as you have pointed out, a number of the tax rules will be expiring at the end of this year, I look forward to hearing whether those tax rules should be extended; and if they are extended, possibly modified. I will also be interested in hearing from the Treasury later concerning the powers it proposes for the new resolution trust corporation to review those past transactions and possibly renegotiate them for the future.

I look forward to hearing from our witnesses today, and thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Vander Jagt.

Mr. Bowsher, if you would like to introduce your colleagues, Mr. Fogel and Mr. Wolf, you may proceed with your testimony.

STATEMENT OF HON. CHARLES A. BOWSHER; COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL FOR GENERAL GOVERNMENT PROGRAMS; AND FREDERICK WOLF, ASSISTANT COMPTROLLER GENERAL FOR ACCOUNTING AND FINANCIAL MANAGEMENT PROGRAMS

Mr. BOWSHER. Thank you very much, Mr. Chairman and members of the committee. On my right is Mr. Fogel, Assistant Comptroller General for our program area which includes the financial institutions. On my left is Mr. Wolf, another Assistant Comptroller General who heads up all our financial auditing and accounting.

What I thought I would do today, Mr. Chairman, is just summarize my statement.

Chairman ROSTENKOWSKI. Your entire statement, Mr. Bowsher, will be included in the record. You may proceed.

Mr. BOWSHER. Thank you very much.

I think what we have to do now is think in terms of the categories of thrifts that we have. In other words, we have about 500 insolvent thrifts, and we really have two categories. Those where action was taken on in the past year; and that is one set. I would like to delve into that in just a minute. Then there are about 350 S&L's where action had not been taken until the administration announced its plan and action is being taken as the FDIC is moving ahead to take control of some of those institutions.

Now, we have just issued our latest report on this subject. The overall problem is about \$85 billion, as we see it. That is over and above what the collections would be from the industry over the next few years. If you wanted a range, I would say the range would be \$75 to \$100 billion. When you add what will be collected, the numbers that the administration is currently using is about in the ballpark with our numbers.

I think you have three big concerns here, and that is that the numbers could go higher if you have higher interest rates than what were used in the assumptions; if you continue to have any substantial deposit withdrawals from the S&L industry—and you have to recognize that the assumptions were based on continued increases in deposits in the S&L industry at about 7 percent, which is a long-term average, but not a recent historic average. Also, you have a substantial number of S&L's that could slip into the insolvent group in the months ahead, depending on the economic conditions of this country in some of the regions. These are the conditions, I think, that could drive the cost of this program up higher.

Now, if I could discuss for a moment the two categories of thrifts. One results from the deals that were made in December. We have a chart over here that I would like to draw your attention to. It is also an attachment to my statement for people that cannot see the chart.

I would like to take you through the typical December 1998 deal. The FSLIC group gives a note for negative net worth. That is for the difference between the assets and the liabilities. Then you have also get a guaranteed return on the assets and a guaranteed book value on the assets. You get reimbursed for certain expenses, like

selling expenses, as you liquidate these assets. You get continued forbearance and some waived regulation compliance; one of the big items would be from capital requirements.

Then you get the tax benefits, and the tax benefits, of course, are important here because, to a great extent, the calculation that was made as to whether to liquidate or to merge the failed thrifts was based on a cost to FSLIC rather than a cost to the Government. Now, FSLIC did it by the law. That is what the law requires, and so that is how FSLIC did the calculation. But the tax benefits, from what we can see—and we are just beginning to look at these individual deals—could be very significant, and we will not know for a number of years how the tax benefits are played out in each individual case. But I think that the tax benefits, as I said earlier, could be quite substantial on some of these deals.

Now, the Government also took an equity position in the new S&L's, generally in the position of warrants, and depending on how they work out, the Government could get some income in the future if they are successful.

Now, what are our major concerns about these deals? That is on the next chart. We are concerned that you still end up with thinly capitalized institutions. These thinly capitalized institutions have a cost advantage over healthy S&L's and, really, other financial institutions, primarily because of the items on the previous chart. In other words, we no longer are just guaranteeing the deposits; we are really guaranteeing most of the operations of these new entities that we have created. That will go on for as many as 10 years.

We also worry about some of the incentives to manage the assets that have been built into the deals. As I have often said in previous testimony before other committees, one of the things in bailout situations in the past, like New York City and Chrysler, is that we always tried to get the reforms before we did the deal. In this case, we did the deals first, and that is why I was very happy to see the administration finally move forward and come up with a plan. I think it is awfully important when you have these kind of bailout situations that the Government makes sure that it gets the reforms in place before we do much of the dealing.

The one time we did not do that, one of the past illustrations, is on the Penn Central Railroad. Some of you may remember that, that is where we did not give a guarantee to the railroad. They went into bankruptcy. We set up the USRA as a financing institution. We poured \$6 to \$7 billion of taxpayers' money into that before we really got some legislation and some management in there, and we were able to turn that situation around in the 1980's. But I worry very much, we do not want that to happen in this situation.

Now, the other thing about these deals that worries us a great deal is their complexity. In other words, I think you are going to have to have a lot of accountants and a lot of lawyers and a lot of tax experts following these deals for years just to monitor them, because as part of the deals, you have to know where things stand. And so I think you are going to have a major job on your hands, and the tax issues are one of the things that makes it fairly complex.

Now, if I could go to the next chart, that is the tax benefits. Just a quick summary of the deductions. They can take the losses on the asset sale. Then you have the preagreement on the net operating losses. The exclusions are where you can exclude from income the interest on the FSLIC notes, the guaranteed rate of return on the assets, the payments for losses on the asset sales, and the payments for certain expenses.

So this is what you have for about 180 of the insolvent S&L's that has been folded into 80-plus new S&L's. And what I say is you have created a new group, literally, of S&L's that will be with us now for a number of years, and the tax benefits here are a major part of the issue with this group of S&L's.

Now, you have got 350, as I said, that have not been dealt with in these deals in 1988, and they are the other ones that will have to be dealt with as part of the President's plan. What you end up now with, as part of this plan, is you really have three insurance plans. You have the FDIC for the banks; you have the FSLIC for the good S&L's in the future; and then you have the work-out insurance fund, which is the one that has to be financed as being proposed by the administration. That will take in both the deals that were done in 1988 and the 350. So you are going to have a combination of S&L's in this work-out situation.

Now, I think one of the major issues that this committee, of course, is looking at is: Should tax expenditures be part of the rescue, or should they be based more on budget expenditures? I think when you do the arithmetic as the FSLIC and the Federal Home Loan Bank Board did on the deals that were made in 1988, they did not calculate what it cost the Treasury because that was not their money. But we strongly believe—and I was pleased to see this in the President's proposal—that you really should look at the cost to the Government, the cost to the taxpayer for these deals.

We truly think you are much better off to structure these deals much like the FDIC has done historically with the banks that they have handled, and that is separating the good assets from the bad assets, make sure you understand each individual situation here, and then make the deal through competition with the people who are willing to compete.

Now, the other big issue, I think, that a lot of people are focusing in on is: Should financing be off budget or on budget? The President's plan has set up another corporation which takes it off budget. It is called REFCO, which is kind of the follow-on to FICO. Here you have, really, again, trying to have the budget treatment such that it is not adding a lot of expenditures to the Gramm-Rudman targets.

I think it forces you, though, to have an increased cost in the program, because you are not going to be financing it through Treasury. You are going to be financing it off budget, and you will pay some basis points above the Treasury rate in order to do it this way.

One thing, though, that we are very pleased with about the administration's program is that it is moving to large capital adequacy requirements for all our financial institutions on a GAAP accounting basis, and I think that that is moving in the right direction.

So, Mr. Chairman, I think that is a summary of the issues and a summary of our concerns, and I would be happy to take any questions that the committee might have.

[The statement of Mr. Bowsheer follows:]

STATEMENT OF CHARLES A. BOWSER,
COMPTROLLER GENERAL OF THE UNITED STATES

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss problems in the thrift industry. My testimony is based principally on a report we prepared for the House Banking Committee. I will also draw on work we have underway for the Senate Banking Committee examining aspects of the complex assisted merger agreements the Federal Home Loan Bank Board (FHLBB) used to resolve insolvent thrifts in 1988.

I hope we are finally reaching a point where a comprehensive approach can be taken to dealing with the issues associated with the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). We estimate that to fully pay for insurance losses and to put FSLIC back on a solid financial footing it will cost at least \$85 billion more than FSLIC currently anticipates receiving in revenue over the next 10 years. Delay will only increase this cost and damage the nation's financial system. If interest rates go up, a recession occurs, or thinly capitalized thrifts become insolvent, costs will increase further.

Without question, federal financing is needed to resolve the thrift industry situation. However, to be as certain as possible that a FSLIC situation is not repeated, we must also change the deposit insurance system. It would be a mistake to commit federal funds without adopting key reforms.

Structural changes

The 1980s have been a turbulent period for our nation's depository institutions. Changes in the financial landscape resulting from market developments and legislated deregulation have drastically altered the way that depository institutions operate. These changes have many positive aspects, but combined with changes in the economy and a breakdown in the regulatory system they have also resulted in new risks and a rash of thrift failures.

In light of these developments, we need to look critically at the deposit insurance system. Our current system provides many benefits to the public that should be preserved, but the risks to the government inherent in insuring about \$2.5 trillion in bank and thrift deposits can be very great. The most immediate problems now are in the thrift industry.

To effectively manage deposit insurance risks it is necessary to (1) have sufficient funds to pay for losses, otherwise the credibility of the insurer is damaged; (2) ensure that capital in insured institutions is sufficient to absorb reasonably anticipated losses; and (3) have a system of oversight and supervision that can effectively and quickly identify problems, require the institutions to remedy them if possible, and close institutions at the point of insolvency.

To accomplish these goals two key issues involving FSLIC must be addressed--FSLIC's lack of independence and the structure for oversight and supervision of thrifts. Presently, FSLIC operates under the direction of the Federal Home Loan Bank Board, which both promotes and regulates the industry. The industry itself is overseen and supervised by the Federal Home Loan Banks, which, in turn, are owned by each district bank's constituent institutions. In our view, the Federal Home Loan Bank System's role as an industry promoter has been accorded more importance than FSLIC's risk management and insurance function.

To deal with these and other issues, we recommend:

- FSLIC should be made independent of the Federal Home Loan Bank Board and provided with adequate examination capability and supervisory authority over both state and federally chartered thrifts. Two separate insurance funds are needed--one fund

for healthy thrift institutions and another fund for insolvent and thinly capitalized thrifts. The latter would be severely curtailed in their ability to compete with the rest of the depository institution industry.

- More flexibility should be given to both FDIC and FSLIC to adjust premiums to reflect actual or reasonably anticipated losses.
- More authority should be given to both Federal Deposit Insurance Corporation (FDIC) and FSLIC to place stringent controls on improperly operated and undercapitalized institutions.
- Greater consistency between banks and thrifts should be established in matters pertaining to powers and operations that materially affect the deposit insurers' exposure to risk.
- Capital adequacy requirements should be strengthened, and the quality of supervision and oversight must be improved.

These and more specific recommendations are detailed in our February 21, 1989, report to the House Banking Committee. The reforms and funding arrangements we recommend should remedy the problems that have occurred in FSLIC. They would also help accomplish a longer run goal of developing an appropriate regulatory structure for depository institutions.

Funding To Fully Resolve Problems Must Be Provided

Insolvent institutions cannot be effectively resolved unless enough money is available. Unfortunately, deciding precisely how much money will be needed and who should pay is difficult. As I indicated at the outset, our best judgement at this time is that it will cost FSLIC at least \$85 billion more than it currently anticipates receiving over the next 10 years to deal with the problem. Of this amount, \$26 billion represents FSLIC's unfunded cost of paying for actions taken in 1988 and \$34 billion represents the future cost of acting on the approximately 350 remaining insolvent cases. In addition, \$5 billion represents the cost of resolving thrifts not presently known to have serious problems, and \$20 billion is needed to establish adequate reserves. However, given the fluid nature of the situation and the fact that the final loss in the closed and insolvent thrifts is not yet known, I want to stress that these numbers are only estimates. Further near-term refinements of cost estimates, we think, should be developed in conjunction with an analysis of the Administration's plan.

While we believe the thrift industry should pay as much of the shortfall as possible, the industry is currently paying premium assessments that are more than twice as much as those paid by the banking industry. Many believe that indefinite continuation of the special assessment will weaken healthy thrifts and thereby prove self defeating. Although we think the healthy segment of the industry should be charged with recapitalizing its new insurance fund, the bulk of the money will have to be found elsewhere. Judgements as to who can pay how much must be made based on what is perceived to be fair. If contributions are not sought from other segments of the depository institutions industry, then the entire shortfall will have to be met by the federal government.

If needed changes to risk management and insolvent thrift resolution approaches are made, we recommend that a plan be adopted by Congress that:

- provides for authority sufficient to resolve insolvent thrifts, which we believe can be completed over the next 3 years,
- assures adequate controls over spending to protect the taxpayers' interests, such as by creating a control board to oversee the resolution of insolvent thrifts, and
- provides flexibility to allow short-term liquidity borrowing to finance any deposit outflows that might occur while efforts are being made to determine the best resolution approaches.

If federal money is used, as we believe is necessary, we recommend an on-budget approach that fully discloses the funding and outlays that are involved, even if this requires raising the Gramm-Rudman-Hollings deficit reduction targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar enterprises that are set up to operate on a business basis.¹

A Different Approach To Resolving Insolvent Institutions Is Needed

At the beginning of 1988 there were roughly 500 insolvent savings and loans with assets of about \$140 billion. During 1988, the Federal Home Loan Bank Board began acting on these cases. The Bank Board acted on about 220 institutions, with most of the activity concentrated in the latter part of the year.

The willingness of the Bank Board to act on insolvent thrifts represents a much needed break from the practices of the past. But, we have serious reservations about the way the Bank Board proceeded.

In recent years the federal government has been involved in several financial rescues. In 1984 we issued a report, based on the government's experience with the Chrysler Corporation, New York City, and several other situations, about how such efforts should be structured.² The guidelines developed in that report underscore the importance of developing an adequate plan for financing, implementing, and overseeing these types of situations.

The Bank Board's actions have not been consistent with these guidelines. Without first implementing reforms and securing adequate funding and staff resources, the Bank Board resolved cases principally by executing assisted merger agreements that extend for up to 10 years. The notes and guarantees in these agreements provided a mechanism for getting around FSLIC's lack of funds and its lack of information on the true financial condition of many insolvent thrifts. Chart I summarizes the generic components of these agreements.

As I noted earlier, at the request of the Senate Banking Committee we are studying FSLIC's 1988 assisted mergers. Although we have not completed our work, we do have concerns about the nature of these agreements. These are summarized in Chart II.

- Ownership capital contributed by private investors has been minimal, and large, thinly capitalized institutions are being

¹See Financial Management Issues, (GAO/OCG-89-7TR, November 1988.)

²Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, Mar. 29, 1984).

created. If history is prologue, inadequate capital creates incentives for highly leveraged institutions to engage in unsafe and unsound management practices. These new institutions may, therefore, pose risks to FSLIC in the future.

- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC and are competing with healthy nonassisted depository institutions at a cost advantage.
- FSLIC provides capital loss coverage and an operating subsidy on assets that could make it profitable to simply hold them. We question the strength of the new institutions' incentives to actively manage and generate recoveries on those assets.
- It is questionable whether many of these assisted transactions, especially when the tax consequences are taken into consideration, save the government money compared to other options that would be possible if FSLIC had had adequate funds and staff resources.
- Finally, FSLIC faces a huge task in effectively administering these complex agreements.

In view of these concerns, we think a different approach should be used to resolve insolvent thrifts. We have recommended that the government take control of these institutions as soon as possible, restructuring their operations until resolution decisions can be made based on a careful assessment of their asset portfolios and the comparative merits of each resolution option. To carry this out, we recommended that the assistance of FDIC and of federal and state regulators be enlisted.

Tax Considerations

Special provisions in the Internal Revenue Code grant substantial tax benefits to acquirers of insolvent thrifts. One provision makes the sale of insolvent thrifts eligible for tax-free treatment as a reorganization without meeting all of the usual requirements. Qualification as a tax-free reorganization and other special provisions allow the acquired thrift's pre-agreement net operating losses (NOLs) to be deducted against the future income of the new thrift.

The rules also enable the new thrift to carry over the full value of assets from the acquired thrift. Because this value is generally higher than the fair market value, there is a loss when the assets are sold. This "built-in" loss is deductible against the new thrift's income and also may be used to offset income of a holding company which owns the new thrift.

Other special provisions provide that FSLIC assistance is excluded from taxable income and is not reflected in the tax basis of the new thrift's assets. The primary FSLIC payments are: guaranteed rate of return on assets; interest on FSLIC note(s); and, reimbursements for expenses and built-in losses. Chart III outlines both the deductions and exclusions. The use of these benefits was recently extended, but reduced by 50 percent, through December 31, 1989.

FSLIC provided us with projections of the tax consequences of the 1988 deals on February 9, 1989. They show tax consequences of \$8.7 billion on a cash basis (as opposed to a present value basis.) We are in the process of analyzing the data and the assumptions used to compute the information.

I want to emphasize that determining accurately the tax consequences of these transactions is very difficult. The true market value of failed thrifts' assets, which affects the tax, is

not known, nor is the timing of asset sales. The future profitability of the new thrift and any holding company are difficult to estimate. And, it is difficult to anticipate the future business decisions of the new owners in light of the tax benefits available.

The special tax benefits, which now apply to banks as well as thrifts, are used in the resolution of insolvent institutions. The need for the continuation of the special tax provisions depends on the extent to which FSLIC, and FDIC, are able to resolve failed institutions using insurance funds only. In this regard, we believe it would be far preferable to take the actions we have discussed to ensure the financial soundness of the insurance funds so that the insurers have the means to pay for, and thus fully recognize, resolution costs, rather than resorting to using special tax benefits. The insurance funds, we believe, should be funded by the industries.

- - - - -

This concludes my prepared statement. My colleagues and I will be pleased to answer questions.

GAO Typical December 1988 Deal

- Note for negative net worth
 - Guaranteed return on assets
 - Guaranteed book value of assets
 - Reimbursed certain expenses
 - Waived regulation compliance
 - Tax benefits
 - Equity position in S&L
-

GAO Concerns About Deals

Creates new thrifts that are:

- Thinly capitalized
- Have cost advantage over healthy S&L's
- Lack incentives to manage assets

May cost more than liquidation

Will require huge monitoring job because of complexity

GAO Tax Benefits

- Deductions
 - Losses on asset sales
 - Pre-agreement NOLs
 - Exclusions
 - Interest on FSLIC notes
 - Guaranteed rate of return on assets
 - Payments for losses on asset sales
 - Payments for certain expenses
-

Chairman ROSTENKOWSKI. Mr. Bowsher, in my letter to you dated February 9, I asked you a series of questions regarding the December 1988 FSLIC transactions. While I understand that you may need more time to respond to my specific questions, can you provide an initial assessment as to your work in determining the amount of tax benefits transferred in those transactions? And when do you think you will be able to respond to the letter and my requests?

Mr. BOWSHER. We can give you a general idea today, but it does take a long time to go through these individually. These deals are really complicated. I cannot stress that too much. And you have got to look at each deal, and the tax benefits are going to be very hard to calculate because it is kind of like safe harbor leasing. When you give people the opportunity to move some losses into another institution and to do the calculations down the road as to how the losses from one group can be used with another succeeding organization, why, you never really know until those tax returns are made out.

But I believe your staff is looking at something around \$8 billion, which is up from what the administration had predicted here. We think it will be all of that. We think it could be substantially more ourselves. But we are working on it, and we are hoping that some time in mid-March or late March we could be more definitive. We would like to work with your staff on this to make sure we are in agreement on some of the issues.

Chairman ROSTENKOWSKI. But you will provide us with that information.

Mr. BOWSHER. Yes, we are working on it.

[The following was subsequently received:]



Assistant Comptroller General
of the United States

Washington, D.C. 20548



March 14, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

When we testified before your Committee on February 22, 1989, on issues related to solving the savings and loan crisis, we advised you that we were continuing to work on the tax consequences of these deals. We have now completed that work.

Enclosed is the result of our analysis. We worked very closely with the Joint Committee on Taxation and the Treasury Department in developing the information relating to the tax consequences of the deals. We have also provided this information today in testimony to the Senate Banking Committee. My staff and I would be pleased to meet with you to discuss this matter further.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
General Government Division

Enclosure

TAX BENEFITS ON 1988 DEALSTAX BENEFITS

The total cost to the government will probably be higher than FSLIC has estimated because of the tax benefits to the acquirers.

Special provisions in the Internal Revenue Code grant substantial tax benefits to acquirers of insolvent thrifts. FSLIC often shares in these benefits. One provision makes the sale of insolvent thrifts eligible for tax-free treatment as a reorganization without meeting all the usual requirements. Qualification as a tax-free reorganization and other special provisions allow the acquired thrift's preagreement net operating losses (NOLs) to be deducted against the future income of the new thrift.

The rules also enable the new thrift to carry over the full value of assets from the acquired thrift. Because this value is generally higher than the fair market value, there is a loss when the assets are sold. This "built-in" loss is deductible against the new thrift's income and may also be used to offset income of a holding company which owns the thrift.

Other special provisions provide that FSLIC assistance is excluded from taxable income and is not reflected in the tax basis of the new thrift's assets. The principal types of FSLIC

assistance payments are: guaranteed returns on assets; interest on FSLIC notes; negative net worth notes; and reimbursements for expenses and built-in losses. The use of these benefits was extended for transactions entered into in calendar year 1989, but reduced by 50 percent.

FSLIC provided us with projections of the tax consequences of the 1988 transactions and the basis on which they made these calculations on February 9, 1989. They showed total tax benefits of \$5.7 billion when calculated in present value terms.

For the 86 transactions resolved in 1988, we estimate the tax benefits, on a present value basis, to be between \$7 billion and \$8 billion. This is consistent with both Treasury and the Joint Committee on Taxation estimates and is about 20 to 40 percent more than FSLIC estimated.

We estimated that the tax benefits for the 12 transactions on which we focused are over \$5 billion on a present value basis--about 20 percent higher than the \$4 billion plus FSLIC estimated.

Our estimate is different from FSLIC's because we used different assumptions. After discussions with tax experts from Treasury and the Joint Committee on Taxation, we decided to use a different weighted tax rate to reflect our assumption that the tax benefits would offset more income at the normal 34 percent corporate rate rather than at the 20 percent alternative minimum tax rate. We reduced the combined benefits of built-in-losses

and income maintenance payments by assigning a tax basis to them as indicated by current IRS administrative practice. Because of tax planning opportunities that are available, we assumed more NOLs will be used.

This is the major reason our estimate is higher than FSLIC's. FSLIC did not consider tax planning but rather relied on their income projections for the new thrifts. We also used a 10-year Treasury rate in calculating the present value of the benefits.

Using these different assumptions for each of the 12 transactions reviewed, we compared the full government cost of the assisted transactions to the FSLIC cost of liquidating the failed thrifts. Our analysis suggests that liquidation could have been less costly for as many as a third of the transactions. FSLIC, however, was not statutorily required to consider tax benefits in deciding whether merger was less expensive than liquidation.

We also estimated the timeframes in which the acquirers' capital could be recovered through tax benefits. In 9 of the 12 transactions, we estimate that the acquirers' tax benefits would equal the capital within an average of 3 years. The range was from 1 to 5 years. Two of the remaining transactions gave all the tax benefits to FSLIC. The other remaining one will not recover the capital through tax benefits during the period studied.

I want to emphasize that determining accurately the tax consequences of these transactions is very difficult. The true market value of failed thrifts' assets, which affects the tax, is not known, nor is the timing of asset sales. The future profitability of the new thrift and any holding company is difficult to estimate. And, it is difficult to anticipate the future business decisions of the new owners in light of the tax benefits available.

FHLBB officials have said that the tax benefits of the transactions were treated like any other asset and included in the negotiations. FSLIC did not have sufficient information to undertake an evaluation of tax benefits at the time the transactions were approved. FSLIC did not estimate the tax benefits of its 1988 transactions until January 1989. It seems highly unlikely that FSLIC got full value for these benefits in all the transactions.

The special tax benefits, which now apply to banks as well as thrifts, are used in the resolution of insolvent institutions. The need for the continuation of the special tax provisions depends on the extent to which FSLIC and FDIC are able to resolve failed institutions using insurance funds alone. In this regard, we believe it would be far preferable to take the actions we have recommended to ensure the financial soundness of the insurance funds so that the insurers have the means to pay for, and thus fully recognize, resolution costs, rather than resorting to using special tax benefits.

Chairman ROSTENKOWSKI. You mentioned that certain other actions to assist troubled thrifts would be far preferable to using special tax benefits. Do you believe that the use of special tax benefits can be more costly than other actions to assist these institutions?

Mr. BOWSHER. Yes, we do. In other words, we think that—we say here in our statement that the special tax benefits which now apply to banks as well as thrifts are used in the resolution of the insolvent institutions. The need for the continuation of the special tax provisions depends on the extent to which FSLIC and FDIC are able to resolve the failed institutions using insurance funds only. So I think you have to listen to their arguments.

In this regard, we, the GAO, believe it would be far preferable to take the actions we have discussed to ensure the financial soundness of the insurance funds. In other words, to have adequate money in the insurance funds so that the insurers have the means to pay for, and then fully recognize, what the resolution costs really are, rather than resorting to these special tax benefits.

I think the tax benefits are hard to calculate when you are in a negotiation, and I think they are going to be very difficult to follow, as the deals call for. In other words, right now you are asking these successor institutions practically to file two tax returns in the future and then to make a calculation of how much FSLIC should receive back from them.

I mean, you are setting up a very complicated method here that you just will not know until several years down the road as to what the tax benefits are. You know, a lot of the people that have argued for this method of putting the deals together say we are attracting private capital. But I think when you really look at the deals, they probably are going to be able to get their capital back through the tax benefits in a relatively short period of time. I think it is more the IRS that may be providing the capital than what you are really getting from private capital.

Chairman ROSTENKOWSKI. Mr. Bowsher, you also note in your testimony that any Federal moneys used to assist troubled thrifts should be kept on budget.

Mr. BOWSHER. Yes.

Chairman ROSTENKOWSKI. Fully disclosing the funding and outlays involved. What are your preliminary thoughts regarding the administration's proposal which may contain an off budget financing component?

Mr. BOWSHER. Yes, it is one concern—we have, really, two major concerns, you might say, with the administration proposal. One is that it might cost more than what they have laid out here. But the second is the off budget treatment issue. I think one thing that bothers me a great deal about the overall budgeting that we are involved in today on Gramm-Rudman is that certain things are kept on budget, it seems like, when they have a positive effect—like the Social Security trust funds and some of the other trust funds. Then as soon as we hit some of these tough issue areas, why, then we figure out how to take them off budget. And I think it has given us a budgeting situation that is clouding or masking the problem that we are really facing.

In other words, I think when you talk about having to come down to \$155 billion in the budget at the end of the fiscal year

1988, which we closed up here, and not have any provision for the S&L crisis, no provision for the nuclear weapons or any of the problems we have over at Defense, I think you are kidding yourself. Then, I think you are also kidding yourself when you are using the trust funds, as we do under the unified budget, because much of the improvement is coming from just the surpluses that we have in the Social Security trust funds and some of the other trust funds. Then, I think we compound it when we take a situation like this, and we start to use REFCO and those kind of corporations to keep it off budget.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Well, I sure agree with you about the phoniness of our budget procedure as it is now set up. I am a product of the Depression and the bank failures then, and I cannot believe that we are back in the same sort of situation that we were at that time.

What caused this?

Mr. BOWSER. What caused these S&L failures?

Mr. GIBBONS. Yes, sir.

Mr. BOWSER. I think the history goes something like this: That in the late 1970's when you had the interest rates going up, and the early 1980's, why, the S&L's obviously were having a major problem between what they were paying for money and what income they had coming in from the mortgages that they had booked over the years on a fixed-price basis.

The industry came to the Congress and to some of the State regulators and argued for greater powers, greater flexibility in running their business, and they were granted that in legislation. Not only were they granted it by Congress but also some of the States gave it.

Then, I think you made a mistake, and that is you did not supervise, did not regulate this industry to find out how it was working. In fact, as we were issuing reports and trying to alert people to the problem, we finally had Mr. Gray convinced that the problem was beginning to build, and he went to get some more auditors and more supervision people from OMB, and he was turned down.

So we had a problem that started out as, I would say, a small problem of a few billion dollars, then started to grow very fast because the industry was getting into trouble.

Now, the thing that fascinates me is how many wheeler-and-dealers got into this industry and really took advantage of these increased powers. So you had a lot of problems just, I think, from insider dealing, from fraud, and from mismanagement. That is one of the reasons why we have this problem around the country.

In other words, there is no question that some of these institutions got into problems because of some regional economic problems. But when you look at the list of the 500 insolvent S&L's, they are all over the country. We have got places in Connecticut; we have got places in Illinois, California, places that have had strong economies. And lots of times, there you see some really bad mismanagement.

Now, I think from the Government's point of view, the problem was not faced up to. In other words, when we again started to show how big the problem was getting here a couple of years ago, say up to around a \$15 billion problem, why, you had some very heavy lob-

bying by the industry that the problem was not big, that it would go away somehow. And so we did not put in any real funds to deal with the problem, and so the problem continued to grow.

Then, I think last year the Federal Home Loan Bank Board tried to deal with the problem without any money, and they put these deals together trying to get on top of some of the failed S&L's. I think myself, unfortunately, that maybe has compounded the problem, and so that is where we are today. I think it is just a series of judgments that were made, and they turned out to be wrong. And I think the major thing it shows is that when we give additional powers or deregulation to a certain industry, it is very important that we supervise it to the point where we know what is happening. And if you are getting unintended results that are going to cost the taxpayer money, you have to move in and deal with those problems. And if you do not, I think this is a good illustration of how the problems have mushroomed and mushroomed.

Mr. GIBBONS. I am not an expert in this industry, but I know that two institutions in my own community are in bad shape. Native net worths are under supervision.

The Department of Justice has moved in on one of them and has convicted some of the directors. The other one just seems to rock along even though it is huge in size and has a huge debt.

How much—I don't know whether there is any defalcation in that, but it certainly looks like there was defalcation in it. How much has the Justice Department done so far in getting behind these messes?

Mr. BOWSHER. Well, they have task forces working in certain areas of the country trying to get at these.

We raised the point before some of the committees about 6 weeks ago that we thought they needed additional resources, and if you notice that was included in the President's plan here.

And, I think they do, because I think that wherever there was wrong-doing, legally wrong-doing—what I think is that the government should go after the individuals. The American taxpayers just are not going to understand this large bailout of well over \$100 billion and people going unprosecuted if the people did wrong.

Mr. GIBBONS. One thing that worries me is that we have honest institutions and we have dishonest institutions. It seems that for legislative purposes we are throwing them all in the same barrel and saying to the honestly run and correctly run institutions you bail out the wheeler-dealers; you bail out the—

Mr. BOWSHER. No. We are really not bailing out the wheeler-dealers. I think that is important, and that is that what the American Government and the American taxpayer is committed to here is the depositors. In other words, the bailout here would be going to meet the commitment of a \$100,000 of deposit insurance through the depositors.

Now, what I do worry about is the deals that were done in 1988 that you have given guarantees here to these managements, and beyond what we have ever had before. And, if you get any wheeler-dealers among the new management groups you would have a contractual commitment there to some of those institutions greater than what you have ever had before up until the deals were made here in 1988.

Mr. GIBBONS. Thank you.

Chairman ROSTENKOWSKI. Mr. Vander Jagt will inquire.

Mr. VANDER JAGT. Thank you, Mr. Chairman.

We are grateful that you are working with our staff to try to get some sort of estimate together by mid-March or the end of March as to the cost of the tax benefits in that flurry of activity at the end of last year with the estimates now ranging from \$4 to \$8 billion.

Mr. BOWSHER. Right.

Mr. VANDER JAGT. Do you suggest perhaps—

Mr. BOWSHER. I think it could be higher.

Mr. VANDER JAGT. Even more than that.

Have you had an opportunity in your preliminary look to form any conclusions about whether FSLIC obtained the approximate value of the tax benefits as they negotiated these deals? Any preliminary notions on that?

Mr. BOWSHER. Yes.

It's still a little preliminary for us to be able to answer that question. We are working on them, and we have had meetings with some of the people who made the deals, and that, but I think it would be better for us to do the work before we comment.

Mr. VANDER JAGT. And, would it be true that even as you try to approximate the value that there could be some benefit in using the tax benefits to persuade a purchaser to take the whole bank rather than just a clean bank. In other words, take the bad assets along with the good ones on the theory, at least, that there is greater asset realization if you get a purchaser to manage the bad assets rather than have FSLIC having to acquire them or dispose of them at bargain basement prices.

Mr. BOWSHER. Yes.

I think that that should be considered, I certainly know that they will put forth those arguments today. And, I think there might be some situations.

But, I think that if you look at the way the FDIC has done the workouts in the past without using the tax benefits like that in most of their deals, why I think you get a cleaner position, and I think you can still get the competition. But, what you have got to do is you have got to analyze each of the banks very carefully before you go into the competition and the negotiation, which is what I do not think we did here.

Mr. VANDER JAGT. So, there would be situations probably where it would be a useful tool?

Mr. BOWSHER. It could be. That is right.

Mr. VANDER JAGT. I think you have spoken very persuasively about how the heavy lobbying by the industry kind of succeeded in putting people to sleep about the urgency of the problem, and mentioned that Mr. Gray could not get additional auditors from OMB. Congress was kind of lulled into inaction, was it not also, by the industry in not taking steps that Mr. Gray was suggesting.

Mr. BOWSHER. Yes.

I think the Congress was, but I think one of the things that made it difficult for the Congress was that the administration people would not come up and say that there was this big of a problem, and then the heavy industry lobbying. I think that is right.

Mr. VANDER JAGT. And, that when Mr. Gray was pointing out some of the wheeler and dealer activity, and wanted to go after it, there was not a quick response, at least, by the Congress.

Mr. BOWSHER. That is correct.

Mr. VANDER JAGT. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Bows her, I am not sure I understand, yet, just where you fit into all of this. The comptroller usually comes to one of these hearings and views with alarm all of the things that have happened after they have happened. Maybe that is the nature of your office, and we have to kind of accept that.

Now, you have recommended that we make some specific changes. You recommend making FSLIC independent of the FHLBB, fund up to \$85 billion, and to put it on budget.

Has the administration talked to you about these proposals? Have you recommended this to the administration?

Mr. BOWSHER. Yes, we have, Mr. Pickle. In fact, we have issued a lot of reports on this subject going back to 1985, and we have met with the Treasury officials and the OMB officials all through this period.

In the past administration we have been in very close contact with the people that put the President's program together.

Mr. PICKLE. You are saying, then, during the Reagan administration you have made these specific recommendations to the administration but had no response from it? And, you have also made these recommendations to the present administration and had no response. Is that correct?

Mr. BOWSHER. No. I think the present administration, the plan that has been brought forward here is very responsive to many of the issues and many of the recommendations that we've made.

My three concerns here, you might say, was the issue of whether you wanted to finance it off budget or whether you want to finance it through Treasury. If you finance it through Treasury, I think it will cost you less—the American taxpayer—than if you go off budget, and we have made that known to them.

Mr. PICKLE. I understand that, and I do not know that I would argue with you about it.

I am trying to say you have made these recommendations.

Mr. BOWSHER. Yes, we have.

Mr. PICKLE. To the present administration—

Mr. BOWSHER. Yes, we have.

Mr. PICKLE. They had not been favored to incline. At least they advanced a different proposal.

Now, it seems to me that you are saying make it an independent agency, raise \$85 billion or thereabout, and do it by funding it and not through tax incentives.

Now, that is opposite to what the President recommended in his plan. So, you as comptroller say that it will not work for the reason that you have given, or at least you can say you can—

Mr. BOWSHER. But, the President's program will work, Mr. Congressman. It is just that it is probably going to cost a little more,

and you are probably not going to recognize the full cost in your budget, but it will work.

And, it has certain advantages from the fact that they can reach out and extract the money from the Regional Federal Home Loan Bank Boards, and I think that is one of the reasons that motivated them to set it up the way they did. They wanted to get a hold of that money as part of the plan.

Mr. PICKLE. I am a little confused. You say yes, we ought to take these specific changes which is contrary to what the President has recommended, but you also say that the President's plan could work.

And I would say you were saying yes on the one hand and no on the other hand. I do not know which position you are taking. But, I am not trying to say that your position should be determined for all you do is just view it and give us a kind of audit report, and that is what your office does.

But, seems to me what you are saying is there is a better way to go about it than has been advanced by the President.

Now, you made a specific statement a minute ago that you thought that decisions made on solving S&L's were the wrong decisions. So, you are criticizing what has taken place.

Now, let me ask you. If we had waited—if the administration had waited—for a recommendation from you or from the Congress—

Mr. BOWSHER. They had our recommendations.

Mr. PICKLE [continuing]. Then we would have to have had action by the Congress, perhaps the FDIC, we would have had to wait for the committees to review it, as well as the Comptroller of the Currency and others. If we did that, the S&L's in my part of the country would have long gone down the drain.

I am not saying what had happened had been the best, but I can understand that action was taken, and had we waited for all of these nice views after the fact, I do not know if we could have saved any of our institutions. At least we did have 87 mergers in the Southwest. We have another couple of hundred more to go, but they are stopped dead in the water, now.

Now, if you make FSLIC an independent agency, you're just contrasting what seems to me with the President's plan to have FDIC take over insolvent S&L's. And, I question whether that should be done. You cannot go with the President's plan and still have an independent agency, it seems to me.

So, I think probably your recommendations are sound, Mr. Bowsher. I do not find fault with them except you sounded like Gabriel after the Resurrection, when you say you people should be good, and you are going to have to pay for your sins. I do not say that critically. It just seemed to me that your offices just do not quite get the information up here to the Hill in time.

So, I appreciate your testimony. I just say that it comes just a little bit late.

Thank you, Mr. Chairman.

Mr. BOWSHER. Well, if I could just respond to that, Mr. Chairman.

We are testifying today here, but we have had our recommendations up here on the Hill for many months, and I think the Bank-

ing Committees in both Houses have had our recommendations, the administration has had—both the old administration and the new administration, and it was not a case that we had to come up here today.

Mr. PICKLE. Thank you, Mr. Bowsher.

Chairman ROSTENKOWSKI. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

You indicate on your chart that some of the reorganizations may cost more than liquidation. Are you speaking of some of those that were put together in December as well as some problem banks that have not been dealt with?

Mr. BOWSHER. We are particularly talking about the December deals, and maybe a couple that were done earlier in 1988.

And, there is really two issues here. The issue of cost, liquidation versus a merger, and that is that there is no question that the Federal Home Loan Bank Board calculated the way the existing law requires it, and that is what is the cost to FSLIC. And, in that case you do not take into consideration what the tax consequences are.

We think that tax benefits should be considered. Not that they were wrong in doing their calculation, but we think that should include tax benefits in considering any future policy here.

Secondly, the ones that are coming—and that is, by the way part of the President's program. They have agreed with that approach, apparently, because that is what they have in there. The second thing that did worry us as we looked at the December deals was that you obviously had some institutions in there that had to be packaged with other institutions before you got to the conclusions that it was cheaper to do the deal rather than to do a liquidation.

So, I think that that's another concern that we had based on these 1988 deals.

Mr. JENKINS. Do you have a ballpark figure as to how many of the deals that were done last year that, in your opinion, we would have been better off to liquidate rather than to—

Mr. BOWSHER. No. We do not have a ballpark figure at this time, but as we work through them, we will have some kind of an estimate in a few weeks.

Mr. JENKINS. So, under the law as FSLIC—

Mr. BOWSHER. We are not saying that they did not follow the law.

Mr. JENKINS. I understand that. But, what they were really looking at is how much does it cost FSLIC—

Mr. BOWSHER. That is exactly right.

Mr. JENKINS. If FSLIC was better off by merging regardless of how much it cost the tax payer—

Mr. BOWSHER. That is correct.

Mr. JENKINS. They went forward with the merger. Is that correct?

Mr. BOWSHER. That is correct.

Mr. JENKINS. In addition to that, you indicate that some of these new structures, new banks are so thinly capitalized that they are going to cause problems, or may cause problems—

Mr. BOWSHER. It could cause problems. That is right.

They could run into some of the problems that some of the other institutions have.

Mr. JENKINS. Do you think that they definitely shelve some of them that we will have to bail out twice?

Mr. BOWSHER. I think there is a possibility. I really do.

Mr. JENKINS. And, you are speaking of the ones that were done last year?

Mr. BOWSHER. Yes.

Mr. JENKINS. In your estimate of some \$8 billion or more in revenue losses from the Tax Code side, is that figure for all of the—assuming that all of the institutions are dealt with, or are you just saying that \$8 billion is for those that have already been done today?

Mr. BOWSHER. The latter. The deals that have been done through 1988.

Mr. JENKINS. Do you have any estimate as to—assuming that we follow through with the same format—what type of loss are we looking at?

Mr. BOWSHER. We are looking at them right now. I just do not think we can give an estimate at this time about the second group.

Mr. JENKINS. Would it be about two or three times the \$8 billion?

Mr. BOWSHER. No, I do not think we can jump to that conclusion.

I think there is enough individuality here about these institutions that you have to look at each of them. And, I think that's one of the major things we try to stress here in our recommendations was that when you are doing these deals, you really have to understand the institution. What are the value of the assets, what are the value of the liabilities? And, so I do not think we can make a generalization at this time.

Mr. FOGEL. Mr Jenkins, one of the things that the FDIC is doing now is trying to develop a model that will take a look at the individual condition of the institution and try to run it through the model to try to estimate for everyone what the tax benefits would be. So, that can be taken into account in the bidding.

Mr. JENKINS. On these new structures, as I understand it, the book value of the new stock has been guaranteed for a period of years. Is that part of that group?

Mr. BOWSHER. The assets? Yes.

The book value of the assets is guaranteed, not the stock.

Mr. JENKINS. Well, basically that translates into stock. Does it not?

Mr. BOWSHER. It does translate into the overall probable loss of the institution, sure.

Mr. JENKINS. So, you have a guaranteed—you have it for 10 years, you have got a no-lose situation, have you not, if you invest in that?

Mr. BOWSHER. If you do not make major mistakes in some of your policies, your loan policies and things like that in the future, you have a pretty much a guarantee of anything that you took over.

Mr. JENKINS. For 10 years?

Mr. BOWSHER. Yes, 10 years in Texas, which is something we have never done before.

Mr. JENKINS. What will that do with another S&L on the corner?

Mr. BOWSHER. It gives the one that is now being guaranteed by the U.S. Government a big advantage.

Mr. JENKINS. Well, I think my time is up, Mr. Chairman. Thank you.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. Thank you, Mr. Bowsher.

Mr. Bowsher, I believe you used the term wheeler-dealer, and fraud and abuse. I think that that portion of this problem is of great concern to the citizens of the country, and if they are going to be asked to dig in their pockets and come up with \$90 or \$100 billion, I think they want to see some action taken.

What action do you believe should be taken, and are there sufficient provisions in the law now to take care of such problems?

Mr. BOWSHER. Yes. I think each situation should be looked at. If there is any suspicion at all as the Government takes over. And, I think a review should be made and I think referrals should be made to the Justice Department for possible prosecution wherever the situation warrants. And, that was one of the reasons that we recommend—I was very pleased, in fact, when the President put that additional money for resources in there.

I do not think the Government is going to get back a lot of money. In other words, unfortunately, I think most of this money that these people might have siphoned off is gone.

But, I think that it is important to look at these situations, if people have broken the law—and I think the laws are pretty good—but they are tough cases. In other words, as we have discussed some of the situations that we were asked to review, first, we were surprised how much potential fraud and insider dealing there was, and second, we recognized that for the lawyers that have to try these cases—it is not easy.

And so, it is a big job to prosecute, but I think the American people are just not going to understand as you do that if some effort is not made to look at these situations, and just give the money out there, there are going to be some very unhappy taxpayers, I think.

Mr. SCHULZE. Do you believe that existing laws are adequate, or do we need some refinement?

Mr. BOWSHER. I think the existing laws are adequate. I do not think that is a problem.

One of the big problems is that the records are lots of times not adequate. In other words, the records are so poor in some of these institutions that putting the story together is not easy.

Mr. SCHULZE. Mr. Bowsher, taxes on commercial real estate were increased in the 1986 Tax Reform Act by at least \$34 billion. In your opinion, did this action, or could this action have had any impact on this savings and loan crisis?

Mr. BOWSHER. It might have had some impact. I would not say that it did not have any impact, but I would not think it would be one of the major contributors.

Mr. SCHULZE. Well, \$34 billion is not a minor amount. But, you say that this would have happened, anyway?

Mr. BOWSHER. I think the problems that we are seeing in the industry would have happened regardless of the tax legislation in 1986.

Mr. SCHULZE. You referred to the 300 and some troubled thrifts. My question is, is there a regional breakdown? Is this—you said there were some in Connecticut, some in Texas, and some in California. But, can you provide for me some sort of a regional breakdown to see whether this is a regional problem, or whether it is balanced nationwide?

Mr. BOWSHER. Yes. You have two really large groups. One in the Southwest, and the other group is in California. And, then the rest are pretty much spread through the country.

If there is anything I think, though, that in addition to the economic conditions, it is the State laws that were passed. In other words, one of the factors that contributed to this situation is that there were laws that gave greater powers to the industry here at the Federal level, and then certain States went further and gave much more flexibility. And, if we see pockets of problems here, then I think that that was a big factor.

Mr. SCHULZE. You think the change in State regulation—

Mr. BOWSHER. Yes. And, I think one of the things that is a part of the solution here is that, and again I think as the President's program has intended, is to make sure that if the Federal Government is going to insure the deposits that we are not insuring deposits in financial institutions that have authority to go beyond what is safe and sound.

Mr. SCHULZE. Mr. Bowsher, how much foreclosed real estate property is currently in FSLIC, or FSLIC-operated institution's, inventories, in dollar value?

Mr. BOWSHER. I do not think we have that with us, but—

Mr. SCHULZE. Can you provide that for me?

Mr. BOWSHER. We might be able to provide it for the record, and we will try.

[The following was subsequently received:]

As of January 31, 1989, FSLIC, in its liquidating receiverships and in its corporate capacity, held a total of \$11.5 billion in assets. That total included \$2.1 billion of real estate property for which clear title was held and \$4.2 billion of loans that might result in FSLIC's acquisition of real estate properties due to nonpayments by the borrowers. Information on the amounts of foreclosed real estate property in FSLIC operated institutions was not readily available.

Mr. SCHULZE. Thank you.

In your opinion, how many troubled thrifts would move off the troubled list if they could dispose of half of their real property inventory?

Mr. BOWSHER. I do not think we can tell that.

Mr. SCHULZE. Well, so you think it would lead to half of the problem—is it half the problem?

Mr. WOLF. Could you ask it again?

Mr. SCHULZE. If you could develop a mechanism—and I have got a point but I am not going to make it right now—if you could develop a mechanism that you could move about half of the troubled real property assets, off their inventory and into the private sector, perhaps through a tax incentive, or some other way—how much impact would this have on the overall problem?

I realize what we have got to do is sit down and figure out the dollar value and whether it would be worth it; if you do not get a

big return it is not worth it. But, that is why I am asking the question.

Mr. BOWSHER. Well, if you take a large portion of the troubled real estate and troubled loans out of these S&L's, clearly many of them will not be as troubled and will be better off. But, moving it out of there, there is already a loss in that property, and somehow you are going to have to reimburse them, and that is, in essence, what is happening whether you liquidate or whether you merge, those assets are being taken off.

Mr. SCHULZE. It also depends if you devise a mechanism whereby that real estate would get returned to some of its previous value, then it could move off at a better level.

Mr. BOWSHER. If we can find a way to make that property worth more money, that certainly would help.

Mr. SCHULZE. I would be happy to talk to you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gephardt.

Mr. GEPHARDT. Thank you, Mr. Chairman.

Mr. Bowsher, you said that a preliminary estimate of the tax benefits, was \$8 billion, and you said that you would come up with a hard figure later. Can you tell me what the neighborhood of that figure would be? You said substantially higher. You thought it could be substantially higher. Can you give us a neighborhood that we are looking at?

Mr. BOWSHER. No, I do not think we can, today, but I would like to give you some idea here in the near future. And, then, of course, you will not know for a number of years as these deals work out because what you are doing is you are trying to marry-up some losses here with some good assets and good returns in probably a new institution.

And, so it will be, I think, very much like the safe harbor leasing situation. You will not know for a while just what the impact of this whole thing is.

Mr. GEPHARDT. Could you give us an estimate of the total cost of the problem, and whether that cost is borne by the taxpayers, or by added premiums on insurance, etcetera? Do you have an estimate now of the total cost of the problem?

Mr. WOLF. Well, we think it is about an additional \$85 billion in addition to the money that is already been committed by FSLIC and everyone else, and they have already committed a total of, really, over time another \$50-odd billion. So, if you look at the total cost to the Government to resolve the whole thing over time, you are up around \$130, \$140 billion.

But, some of that we have already paid. What we have estimated is you would need at a minimum an additional \$85 billion which could go higher than that. The administration's estimate is around \$90 billion, some estimates now go up maybe, over \$100, \$120 billion even.

Mr. BOWSHER. One thing, of course, that is included in this estimate is the rebuilding of an insurance fund for the healthy thrifts. In other words, we cannot continue to run an insurance fund with no money in it for the healthiest thrifts.

Mr. GEPHARDT. Do these figures take into account higher interest rates that appear to be on the horizon?

Mr. BOWSHER. No. Most of these projections have been—well, the administration's projections have been at the interest rates that were assumed in the President's budget—and that could be, as I said earlier, one of the things that could drive this higher.

Mr. GEPHARDT. How much does the total cost increase for each point that interest rates go up over those estimates? Do you have any idea?

Mr. BOWSHER. We are trying to do those calculations now, but we do not have an answer for that?

Mr. GEPHARDT. Could you communicate that estimate to us when you get it?

Mr. BOWSHER. Yes.

[The following was subsequently received:]

The plan's funding arrangements rest on the optimistic assumption that interest rates will fall rather sharply from their level at the end of 1988. The plan assumes a normal yield curve and a fall in the rate for long-term Treasury issues from 8.8 percent in 1989 to 6.2 percent in 1991. Recently, however, the long-term Treasury rate has risen to over 9 percent and yield curve changes have brought many short-term rates above long-term ones.

Rising interest rates and changes in the yield curve can increase the cost of the plan in a number of ways. Some of those ways can be measured fairly easily. For example, CBO has estimated that the rate for 30-year government bonds will average 2 to 3 full percentage points higher than the rates assumed in the plan. This would result in an increase in interest costs on REFCORP bonds of over \$9 billion for the 1989-1999 period. Higher interest costs would also increase the subsidies built into the deals FSLIC used to resolve cases in 1988, although the interest rate assumptions used in estimating the costs of these deals are higher than the basic assumptions that have been used for the plan as a whole. These higher costs would be partially offset by a \$2 billion reduction in the amount of money needed to purchase zero coupon bonds to defease the principal of the REFCORP bonds.

Higher interest rates and changes in the yield curve also make it more likely that additional thrift institutions will fail. This influence is particularly difficult to quantify, but several government and private estimates have been made, ranging from 15 additional insolvent thrifts if rates rise 100 basis points, to 1,000 more insolvent thrifts if rates rise 300 basis points. The difficulty of making such estimates for thrifts is aggravated by FHLBB's unwillingness to release information it collects each quarter that would provide insight into institutions' exposure to interest rate changes. Recession, too, which many economists think is likely in the next several years, would tend to increase the number of thrifts that fail.

Mr. GEPHARDT. And, how much less would the cost be than these figures if we had some plan for more immediate liquidation of all those institutions that have not been dealt with, but are on the very marginal or bankrupt list?

Mr. BOWSHER. Well, that would not be easy to do. In other words, what you have now is contractual arrangements with the ones that the deals have been made for in 1988. And, there are some features in those deals where you can pay up sooner, you might say. But, also, you have to recognize that you have a lot of assets out there that are going to take some real time to work out. You cannot dump all of these assets onto some of these economic areas without driving the problem either further into the hole, or increasing the cost, you might say.

So, I think there is going to have to be a lot of good judgement used by the FDIC and the people that are going to be responsible for this program, not to compound some of the problems in some of the areas.

The real costs of this program will not be known for quite a long time, I think. The estimates that we are all working with here are

useful, but truly the cost of the program—it is going to take some time to know what it really is.

Mr. GEPHARDT. Finally, I would like to ask you some questions about OMB and the administration and the requests that were made for additional personnel to police the S&L's.

You said earlier that OMB had overruled some requests for additional personnel by FSLIC. Can you tell us how many times that happened, and how many people FSLIC was asked to provide but failed to provide?

Mr. BOWSHER. We will try to go back and get that information as how many were asked, and things like that, but there was one major request there, which was about 2 or 3 years when Mr. Gray saw that the problem was growing, and that was when he was turned down. I think it was toward the last year of Mr. Stockman's tenure at OMB, and I think the decision indicates one of the unfortunate problems that we have now with these large deficits. In other words, people often ask what is wrong with the large deficit?

I think one of the problems is that we are lots of times not able to face up to the problems and do something about them because we are so concerned about trying to live within the budget numbers. And, I think another one that I am spending a lot of time on right now is the nuclear weapon plants. We have got another \$100 billion problem in that area, and that is a lack of investment over the last several years, 10 or 15 years.

Now, we are going to have to spend just an absolute fortune to handle the environmental problems and the reactor modernization problems.

Now, I think these two situations illustrate what I see is a real problem here now in the Government operations. We just do not face up sometimes when we recognize we have a problem, and I think this request for additional auditors in the S&L is a good illustration.

Mr. GEPHARDT. Is it also likely that requests for additional personnel to prosecute the people who were the wrong doers in problem S&L cases will be denied?

Mr. BOWSHER. Again, I am pleased to see the President did include some additional funds and resources in the program.

Mr. GEPHARDT. I wonder if it is enough.

Thank you, Mr. Chairman.

Mr. GIBBONS [presiding]. Just let me observe before I go to the next witnesses, that the same thing is happening in Medicare. We just do not have enough people out there monitoring that program, and I predict it is the next big scandal that we are going to have around here, is how much money has been run off with in that program.

How many people do you have working on Medicare?

Mr. BOWSHER. About 150 staff-years.

Mr. GIBBONS. How many people is that? Ninety people?

Mr. BOWSHER. Well, 90 people for 1 year, and that is a continuing situation, Mr. Congressman.

Mr. GIBBONS. We could use that many in my district. OK. Well, let's go on. We have Mr. McGrath next. Is Mr. McGrath here? No. Mr. Chandler? No. Mr. Frenzel? No. Mr. Sundquist.

Mr. SUNDQUIST. Pass, Mr. Chairman.

Mr. GIBBONS. Mrs. Johnson.

Mrs. Johnson. Pass, Mr. Chairman.

Mr. GIBBONS. All right. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. BOWSHER, I think that your testimony is very good and very sobering, and I greatly appreciate it. It helps me to understand this a little more clearly and I thank you for that. I want to deal with the questions that GAO has about the new deals. You have listed your list there.

When the Federal Home Loan Bank Board was putting together these deals, I assume that they knew all of the things about the recommendations that you have made, and others have made, about what was wrong with this industry.

In part, I assume they contribute to some of the concerns. If you had to do this over again, looking at these deals that have been put together, would you say to them, we just do not think this is a very good plan, think of something else?

Mr. BOWSHER. Yes. I have testified before Congress saying that I think it would have been much better to wait until the Congress and the administration could agree on a plan, and that there would be some real money to handle these situations.

In other words, I think what they tried to do was to work the deals without any money, and, in order to do that they had to then go to tax benefits and tax expenditure situations, and guarantees, and my big concern was that we did not get the reforms before they started putting the deals together.

And at the same time I recognized what they were up against. They had no money.

Mr. DOWNEY. Sure. And they were also under the gun to do something.

Mr. BOWSHER. That is right.

Mr. DOWNEY. So this is part of a kind of an interesting, ongoing set of crises, that for years, in part, GAO was warning us about, nothing was done, there were no additional auditors, there wasn't a more careful scrutiny of the activities of these people.

Sadly, a capital crime in our country is one when you take a life or do an act of violence. A capital crime here, it would seem to me is managing over the course of years to diminish the net pool of assets and savings that this Nation has. Because each one of these savings and loans that corruptly or stupidly, or avariciously decided that there was some investment that really was not a good one, has really diminished the national wealth in a way, has it not?

Mr. BOWSHER. Well, yes, I think it has. In other words, I think, again, one of the things that motivates people for saving is if they feel their savings are being well-handled, and being preserved properly.

And I think when they see scandals like this, it must have an impact on the level of savings. And of course we have a very low savings rate in this country, to begin with.

Mr. DOWNEY. Well, I mean, isn't the capital stock of the Nation just a little bit less because of the imprudent investments of these individuals?

Mr. BOWSHER. Yes. I think that is a fair statement.

Mr. DOWNEY. So isn't it further true, that if the capital stock of the United States is less, that the real income to the people, the value that we would derive from prudent investments would be greater? Now it is less. Our standard of living, to a certain extent simply by the bailouts, will also be less?

Mr. BOWSHER. Yes. I think that is a fair statement.

Mr. DOWNEY. Well, obviously the President has come up with a plan, and we will scrutinize it. I, frankly, would prefer a more direct approach that recognizes more immediately that there are costs, and that we should deal with them as opposed to having jury-rigged plans of tax schemes and the like.

But I am concerned, and I believe this concern is shared by Mr. Gephardt—and he and I were discussing this—and other members of the committee, that the process of looking at the greed, and the stupidity and the potential crimes that may have been committed, is a component part to restoring some of the confidence that the American people have in the system.

Frankly, if they were looking at the Government today, I think they would give us some pretty bad marks—all of us—not only in the Congress and the administration—for the fact that we had been warned about this problem, explained that there were serious problems that were in the works, and did nothing about it.

And then when we decided to do something about it, without money, we made further mistakes. I do not believe that this is a very happy chapter in the financing of this country, but, more importantly, it is going to have to be a chapter in American economic history where some of the people who have been culpable are brought to the bar of justice, if we are ever going to explain to people in New York—as I will have to explain—that we are going to insure very large deposits.

We are going to raise, possibly, taxes to do this. But that the cases, you see, are too difficult and too hard to resolve about the people who misspent the money.

Do you have any idea—I mean, you said yourself that the cases to bring some of these people to the bar of justice would be expensive.

Do we have any idea of that expense? As Mr. Gephardt mentioned before, that President Bush has included some money. Is it enough, and can you give us some idea of what would be enough to go after some of the people who really screwed this up, to make sure that they are held accountable?

Because I do not believe we are going to be able to go along with raising a lot of revenue, and then just washing our hands, and saying, well, we are not going to go after the people who are principally responsible for this.

Mr. BOWSHER. No, I think you will have to ask that question of the Attorney General as to how much resources he is assigning to it, and whether he thinks he will have enough resources.

Mr. DOWNEY. Well, my time is up. Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman. Welcome, Mr. Bowsher. I would like to follow up on a couple of comments that were made by my colleagues.

You made a comment about investment, and that you felt Congress and the administration had failed to authorize investment, that is, we had failed to give proper staff and money to the regulators so that they could do a proper job.

I spent 10 years in the courtroom and I was a trial lawyer, and I know how difficult those cases are. Here is a case where, had we spent some money on the front end, it probably would have been a lot cheaper than on the back end, and we would have stopped it rather than trying to find somebody guilty. We would have weeded out the problems up front.

I hope we learn a lesson from that, and if Mr. Gibbons is correct, when it comes to Medicare and other issues, that we do not just take a look at the budget and get myopic about that, and do the proper investment.

There are two things that you have put on your board, and Mr. Jenkins brought up, and over on the lefthand chart you have "Cost Advantage Over Healthy S&L's," and he mentioned any S&L that might be across the corner. Well, in my case it would be across the State line. I represent a district in southwest Arkansas.

The Southwest plan included a lot of tax benefits to bail out a bunch of Texas S&L's. How can you ascertain whether or not the tax benefits went to a broad area, or whether or not the tax benefits went to a very targeted area, that is, Florida, Texas, and California, to the exclusion of smaller States like Arkansas, and other States who have also had problems?

Mr. BOWSHER. Most of the institutions were in the Southwest, and some in California, but one thing you have to consider is that some of the new owners are from other parts of the country, and so we could probably give some breakdown on that.

Mr. ANTHONY. Well, I wish you would do that because Mr. Wall is going to testify later.

He and I have had several very pleasant conversations about this matter. I called him personally in December. I wrote him a letter to urge him to distribute these tax benefits evenly. I do not want the fat cats, like Ford Motor Co. and the Bass Brothers, and all these other people to have the benefits at the expense of my constituents.

I want these little folks in Arkansas who pay taxes to get the breaks, too. So, if you could give us a breakdown as to whether or not these tax benefits were shared generally and equally around the board, I would like to know that.

[The information of Mr. Bowsher follows:]

The number of thrifts sold during 1988 in FSLIC-assisted transactions totalled 179 in 26 States is as follows:

FSLIC-ASSISTED TRANSACTIONS BY STATE AND NUMBER

State	Number of thrifts	State	Number of thrifts
Alabama	1	Minnesota	5
Arkansas	1	Montana	1
Colorado	3	New Jersey	3
California	13	Ohio	5

FSLIC-ASSISTED TRANSACTIONS BY STATE AND NUMBER—Continued

State	Number of thrifts	State	Number of thrifts
Florida	6	Oklahoma	4
Georgia	1	Oregon	3
Iowa	10	South Dakota	1
Idaho	1	Tennessee	3
Illinois	15	Texas	80
Indiana	6	Virginia	2
Kansas	1	Washington	5
Kentucky	1	West Virginia	3
Michigan	3	Wyoming	2

Mr. ANTHONY. You just led me into my second question. Unfortunately, we had one of the biggest early bankruptcies of a savings and loan in Arkansas, and the institution was bought by a company in Kansas City, Missouri.

All over the State people complained that they offer high interest rates, the money is deposited, and the money is siphoned off to Missouri, and other places, to be invested, and development occurs in other places rather than in the State of Arkansas.

And in fact if you look at table II in one of the booklets that was handed out, of the severely insolvent savings institutions, the residential mortgage-related loans in 1987 had dropped to 33.5 percent for troubled S&L's and in June of 1988 it was up to 35 percent. Yet mortgages compromised at 62 percent of the loan portfolios of healthy S&L's.

So this chart seems to bear out the fact that they do siphon off the money, they do not reinvest it in what they were intended to do—home mortgages—and I wish that you could maybe share with us, either orally or in writing, your thoughts on how we could solve that problem.

[The information of Mr. Bowsher follows:]

We cannot be certain to what extent acquirers are channelling funds to investments in areas other than the failed institutions' home State. Presumably, acquired institutions are able to exercise the powers of their charters to the same extent as other institutions. There is legislation currently in place designed to regulate the extent to which institutions invest in their communities. The 1977 Community Reinvestment Act requires financial institutions to meet the credit needs of all segments of their communities. The 1977 Housing and Community Development Act requires financial institution regulatory agencies to take into account an institution's record of serving the credit needs of its community when evaluating applications for new facilities, mergers and other matters.

The Competitive Equality Banking Act of 1987 (CEBA), requires that thrifts be able to pass a qualified thrift lender test (QTL) by maintaining at least 60 percent of their asset portfolios in qualifying housing related investments. However, FSLIC generally provides troubled institutions and/or acquired institutions forbearances from various regulatory requirements. At the present time, we do not have available data to determine to what extent acquired thrifts are investing in other than housing-related investments, or to what extent institutions are being given forbearances from the QTL requirement.

Mr. ANTHONY. In fact I had——

Mr. BOWSHER. I think you are raising a very good issue, Mr. Congressman, and that is that as we look into some of these deals, and as we talk to some of the people in the private sector who are a

part of these organizations, it fascinates me to see how much of the lending was done out of State.

In other words, you have an awful lot of the institutions, a large number of them, were out there dealing in other parts of the country.

Mr. ANTHONY. Well, you are talking in the original, failed institutions.

Mr. BOWSHER. The ones that were done in 1988 are the ones—

Mr. ANTHONY. Well, I think that is a result of the fact that we gave them all of these powers and they jumped on a fast-moving train not knowing where it was going, and ended up in some bad deals.

Mr. BOWSHER. Yes. It is also one of the reasons that I worry a great deal whether we are going to have another group starting to fall into the bad company group, you might say, just because of the complexity of the deals, and that as some, you know, get worked out, it is going to have an impact on some of the others, I am afraid.

Mr. ANTHONY. Well, I would just ask you, as you continue your study, to take a look at two things.

Back on June the 13th of 1988 I got a response from the Federal Home Loan Bank Board about an inquiry about how many loans were being made in the State of Arkansas by this institution now headquartered in Missouri, and it was very frightening how many loans had not been made.

They said there were a lot of loan applications in progress, but they had been in progress for a hell of a long time, too.

I served on a savings and loan board for 4 years, I closed loans for 4 years, and I know that it does not take a long period of time to do it, if you will sit down, read your abstracts, and draw up your papers and get on with the program.

So it appears to me that there is a lot of other disadvantages other than tax benefits being shared with the few and not with the many.

And had we put it on the budget, and had we done it out of General Treasury funds, then everybody would have been in the same boat and treated equally.

Mr. BOWSHER. That is right.

Mr. ANTHONY. And I applaud you for your efforts in trying to ferret it out. It is a sticky wicket, and I hope we are not short-sighted and fail to invest in other industries and get caught in this same situation. Thank you.

Mr. BOWSHER. Thank you.

Mr. GIBBONS. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Bowsher, I would like to talk a little bit about the bidding process of FSLIC, and whether or not you feel comfortable, and whether the American people should feel comfortable with the bidding process.

Mr. BOWSHER. As they went through to meet with the people that were bidding, they were using the procedures that they had set up, but as we have looked at some of these deals, they obviously were not following some of the procedures that had been built into

the Government procurement rules over the years, to try to make sure you have a fair competition.

We have heard a lot of anecdotal statements by some people in the private sector, that they feel it was not done well at all.

It is not anything that we have a definitive report on at this point in time, but there obviously are some concerns out there about how the deals were made, and who was excluded and who was left in at the end.

Mr. COYNE. Have you had a chance to review any of the deals that were made to see if the—

Mr. BOWSHER. We are reviewing those now.

Mr. COYNE. You are reviewing them now?

Mr. BOWSHER. Yes.

Mr. COYNE. To see if the taxpayer got the best deal that was available in the bidding process?

Mr. BOWSHER. I am not sure we will be able to come out with that answer, but we will be able to come out with our concerns, where maybe we think that some of the pieces of the deals left you with some concerns, you might say.

Mr. COYNE. About the process?

Mr. BOWSHER. About the process, too. Yes.

Mr. COYNE. Thank you.

Mr. GIBBONS. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

I would like to ask you to go back to your testimony, and to discuss with us a little bit more the tax incentives.

Tell me, in your opinion, has it been the most efficient way to assist the thrifts? Has it been a critical part of the transactions?

And I guess more importantly in terms of what the committee does: What do you think the impact would be, if we allow these benefits simply to expire?

Mr. BOWSHER. We think that the benefits are hard to calculate when you are in a negotiation because you do not know all the situations of how they might be used, and I think that the negotiations were to be done in such a hurry that they also did not have the time to really analyze the individual institution's assets and liabilities.

And I think many of the private-sector groups that have gone into these deals are just now sorting it out themselves. They had a pretty good idea of what they were going into. They had a lot of top lawyers and accountants working with them.

But the time was of such short period, you might say, that I think that the Government did not have a full realization of where they were, and so the tax benefits were not one of the things that people gave a lot of thought to.

I think also the private-sector people are always anxious to get their capital out through tax benefits if they can, and I think that is one of the things that you will see here in the next 2 or 3 years, and that is that some of the people that have gone into these deals will try to do just that.

And so how much it is going to be we are not sure. We are going to try to give some estimates here as we look at these individual deals, but I think it is going to be some time before you have the answer on that.

That is why we do not recommend that the other 350 institutions be dealt with on this basis. We think it is much better to deal with them without using tax benefits, unless there is some very unique reason why it is to the advantage of that particular deal.

Mr. FOGEL. If the acquirers did not have the tax benefits, the Government would have had to have more cash up front to pay for them, and then, if you go back in history—and you may want to ask the FDIC about this—in the historical way that they dealt with liquidating banks, they basically did not use a lot of special tax benefits.

But you had to have more cash up front.

Mr. ANDREWS. That is right. They found it more efficient and less expensive, in their opinion, in the long-run, rather than use tax incentives.

Are you suggesting that might have been a better approach here?

Mr. BOWSHER. Yes. That is what we are suggesting, sir.

Mr. FOGEL. But what you have to recognize is that the Bank Board did not have the cash, and as we related earlier, it was a result of a whole consequence of problems, and a failure of a lot of people to recognize that we had to provide more money, quicker, up front, to deal with the problem, and as a result of not doing that we have got ourselves in this dilemma today.

Mr. ANDREWS. If either the administration or the Congress revisits some of these deals, what would be your thoughts about those tax incentives? If we abrogate those kinds of arrangements, would that have a negative impact?

Would it have a significant impact?

Mr. BOWSHER. I do not think you can. In other words, I think each deal should be looked at, but I think that you basically have a contractual arrangement now with the people that the Government made the deal with.

Mr. ANDREWS. Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Levin, and then Mr. Moody.

Mr. LEVIN. Thank you, Mr. Chairman.

Let me first ask you one detailed question. On page 5 of your testimony, you say, "In addition, \$5 billion represents the cost to resolving thrifts not presently known to have serious problems."

How do you arrive at that? I know you later say it is an estimate.

Mr. FOGEL. Well, in addition to the 350 that are now insolvent, there are around a 100—although it is a floating number—but there are about 100 other thrifts that are very thinly capitalized, and if we did not recognize good will, may be in trouble, on a GAAP basis—so what we have included as an estimate in the amount of money that you need, an additional \$5 billion, assuming some of these 100, over the next several years, may get to the point where they become insolvent.

Mr. LEVIN. What is the worst-case scenario?

Mr. BOWSHER. Well, the worst-case scenario I think is the one that Booz-Allen or some organization is saying, that there are 1,000 additional institutions out there that might fall into the insolvent category.

We do not feel we have enough evidence to hold that out as being something that might happen, but I think that if you wanted to think about the worst case, it would be that you have high interest rates or poor economic times like a recession.

If you had some of these very thinly capitalized institutions falling into the insolvent category, the numbers could run up, and then you would have a much larger problem.

Mr. LEVIN. But take your assumption of what, a 100 or so?

Mr. BOWSHER. We used 100, and we basically derived it by backing out the good will.

Mr. LEVIN. Right. Take the 100 or so: What is the worst-case scenario within some limits of reason about those 100. What would it cost?

Mr. BOWSHER. That is the \$5 billion.

Mr. LEVIN. But does that assume that all of them went sour?

Mr. BOWSHER. I think that does assume that those 100 would drop into the insolvent category.

Mr. FOGEL. Not necessarily. That is one of the difficulties in coming up with firm estimates of how many are going to go under.

I think if it would be a worst-case scenario it would be more than that, and we could get you the details.

Mr. LEVIN. Would you do that.

Mr. FOGEL. Yes, sir.

Mr. LEVIN. On the 100.

[The information of Mr. Fogel follows:]

In our February 21, 1989 report (GAO/GGD-89-47, Solutions to Thrift Problems), we estimated that FSLIC would need additional funds to pay the costs involved in taking action during 1989, 1990, and 1991 amounting to at least \$50 billion. We also estimated that FSLIC would need funds for resolving future problems from the more than 2,500 remaining institutions insured by FSLIC, 363 of which had less than 3 percent GAAP net worth. Although we had no empirical basis for estimating such losses, we included \$5 billion in our funding estimate to formally recognize the potential for losses from these institutions. We recognized at that time that losses could easily become larger than this estimate should a recession or periods of high interest rates occur or if no improvements are made in the ability of the deposit insurance system to manage its exposure to possible losses.

Mr. LEVIN. And I think you have done a spectacularly insightful job, and so I am not asking you for more than you are able to present. But it seems to me that what we need to do is to be realistic about the problem, and if \$5 billion is possibly an understatement, I think we want to know that.

Because as you have pointed out so dramatically—and I hope the facts you have given your testimony a few times will not undercut the drama of it—this is a picture of a period of worse than sadness, and even tragedy. This is a disgrace. As you said to Mr. Gephardt a \$135 billion and in your answer to Mr. Downey, and others, we failed to take preventive action that would have cost a fraction of the \$135 billion.

So let me just ask you, as astute observers of Government, what is the problem? You mentioned the nuclear plant problem as another example.

Why did Government get into this situation? There were others in the private industry that are largely responsible for creating this. We did not, in a sense, create it, but we did not take the steps to prevent it or to obviate it.

What are the dynamics at play here? Why this horrendous series of events?

Mr. BOWSHER. I think any time you change policy, as you did in this industry, you have to monitor it, and you have to have enough confidence on the Government's side to, one, go out there and find out what is going on, and then if you find out that problems are developing, you have got to then have enough confidence on the Government's side to build a program to get on top of that problem.

Mr. LEVIN. I agree. Why did that not happen?

Mr. BOWSHER. I think it did not happen because we did not have a large enough staff over there.

Mr. LEVIN. Why didn't we?

Mr. BOWSHER. Well, one of the problems is, see, when you gave these additional powers, this industry grew tremendously, and so the same number of people all of a sudden had to watch an industry that was much different.

Mr. LEVIN. Yes, but why didn't we take them—

Mr. BOWSHER. It was basically the decision I think at OMB, that did not want to give the additional resources to the Federal Home Loan Bank Board at that time, and I think the Gramm-Rudman targets—a downside of having a mechanical process for budgeting which has certain advantages. No question about trying to get on top of the budget deficit.

But I think when you have problems, you have got to address those problems, and if you do not, then it gets worse. And what is amazing in a couple of these situations is how fast the problem grew.

Mr. LEVIN. Thank you.

Chairman ROSTENKOWSKI. Mr. Moody.

Mr. MOODY. Thank you, Mr. Chairman.

I, too, want to compliment you on excellent testimony. It is very insightful and extremely helpful.

I want to ask you about the implications of this whole new approach, the December approach, you might call it. We are now going far beyond guaranteeing deposits up to the \$100,000 level.

It seems we are going from a minimalist approach of regulation because we cut the staff down—almost deregulation—to now where we are literally in bed with these S&L's.

As you say, we are guaranteeing the value of their assets; we are guaranteeing the value of their return on assets.

The Government has practically flipped from one extreme to the other. It is virtually a form of socialism inside the S&L industry, but it is done in a very peculiar way because it only applies to certain institutions, in fact the ones that are in trouble, and the ones that now have these guarantees.

It is a major ideological and institutional threshold. We seem to have crossed in the middle of the night without anyone noticing very much.

Mr. BOWSHER. I think that is very true, Mr. Congressman, and that is what worries me a great deal, and that is that some people would say you even nationalize these institutions because the Government is going to be there and involved here now for a good number of years.

And you have got literally the hose hooked up to the Treasury for those same number of years, and a lot of money could pour out. A lot of money could pour out in payments and also in reduced taxes for somebody.

Mr. MOODY. We are not even sure what the Government's exposure really is.

Mr. BOWSHER. That is correct.

Mr. MOODY. Because a lot of it will depend on the prudence and the efficacy of the management down the line, and as you say, the incentives for tough management are, if anything, reduced.

Any time you share your burdens, or share your losses, your incentives for tight management have obviously, to be reduced.

Mr. BOWSHER. And that is why we have stressed very strongly here why we recommend the approach of dealing with these institutions much more like the FDIC has dealt over the years, as Dick Fogel pointed out here, but you have to have cash to do it.

In other words, it was a case here of moving forward without cash, and trying to work some deals to get on top of the problem.

I commend the people who wanted to get on top of the problem, but I really think it was a misjudgment myself.

Mr. MOODY. Right. Well, they were in a tough spot. They had to act with some dispatch and they did not have the cash. So, for a shortage of cash, we have turned the corner, a major corner in this country in terms of the Government's relationship to at least some financial institutions. That seems to me very significant and not entirely noticed up until your testimony.

The other point you raised that caught my attention is the unlevel nature of the playing field when the Government has this relationship with certain members of the industry and not some of their competitors.

Do you want to elaborate on your concern there.

Mr. BOWSHER. Well, I think the concern is that these people here are getting assistance, and are going to continue to get assistance and guarantees here that will have to be made good on, and the other people out there are much more on their own.

And our traditional relationship here is we have insured the depositor up to a \$100,000. We have not, in any way, guaranteed the overall operations of a financial institution.

Mr. MOODY. Right.

Mr. BOWSHER. And in this new group, that is where you are at.

Mr. MOODY. For the troubled ones, we have actually in effect gone far beyond the \$100,000, have we not?

Mr. BOWSHER. It could well work out that way. That is correct.

Mr. MOODY. If anything, we have extended the \$100,000 cutoff without actually enunciating a policy change.

Is that an accurate statement?

Mr. BOWSHER. I think that is fair statement.

Mr. MOODY. Sir? Mr. Fogel?

Mr. FOGEL. I was going to say that, you know, all the institutions are competing for a small pool of deposits, and we are not guaranteeing anyone's deposit above \$100,000 in any institution.

But when you have got a small pool of deposits, and you have got one institution down the street who is guaranteed a rate of return, they may be able to have different interest rates and do things for

their depositors that a healthy S&L or a bank down the street could not do.

Mr. MOODY. So we may be pushing some of the healthy ones towards the brink by the nature of the bailout you are describing?

Mr. BOWSHER. I think some of the healthy ones feel that way, and they have made their feelings known.

Mr. MOODY. What do you believe is the sensitivity of the cost of the bailout to rosy interest-rate assumptions?

If you changed 100 basis points on the interest rates, what does that do to the bailout cost?

Mr. BOWSHER. We are working on that and we will submit that to the committee, and to you.

[For information see p. 92]

Mr. MOODY. How is it that GAO told us last year it was probably about a \$39 billion problem, and now we have virtually tripled the cost to \$135 billion?

In one short year you see the problem as having tripled. Did it triple, or did we not have the instruments to know earlier?

Mr. BOWSHER. It did not quite triple because the \$39 billion did not include the amount for the new insurance fund. In other words, that is \$20 of the \$85 billion. The \$39 billion did not include the \$5 billion for the other hundred in that, so it really went from \$39 to somewhat over \$50, maybe \$60, you might say.

And the reason it did is that every time you went in and finally worked out one of these situations, what had happened was it was costing twice as much.

In other words, when Fred Wolf and his people do the financial audit of FSLIC every year, we get an estimate from the organization as to what they think the situation is on these insolvent thrifts, and they come up with an estimate and we have generally added to it, and say we think it is more serious.

But as the workout situation has happened generally the cost lots of times has doubled, and so it is really the fact that these institutions have been in more serious trouble than what was estimated.

Mr. MOODY. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Pease?

Mr. PEASE. Thank you, Mr. Chairman.

Mr. Bowsher, I thank you and your colleagues for your splendid testimony.

Time and again the GAO comes before this committee, and provides testimony which gives us all reason to be proud of the GAO as an arm of the Congress.

I would like to ask a question about the insurance of accounts in savings and loans. Currently, that insurance is \$100,000 as you know. Currently, one can put \$100,000 in several institutions and have \$100,000 in each of those institutions insured. We are aware that there are brokered deposits where brokers will take your \$5 million and divide it among a number of institutions as \$100,000 each, and you get the insurance in each case.

In that situation, it seems to me that the broker and the owner of the assets both have every reason to want to maximize their return, therefore, placing the money in institutions which provide the highest return, not necessarily the safest institutions.

Can you give me any notion at all of the degree to which the current law providing for multiple \$100,000 insurance policies, if you will, contributed to or exacerbated the problem that we are in now?

Mr. BOWSHER. I think the whole concept of these brokered deposits was a factor in the problems building up here because as you rightfully point out, they lots of times went to the institutions that were willing to pay a little more no matter what their financial position was.

And, I do not think it is the \$100,000 as much as the fact that the brokers and the "hot money" as they often refer to it could move around the country and go into institutions that really should not have been growing. That's the way that they were keeping on operating.

I think one of the classic cases was this S&L in Fort Worth where, when they finally closed it down, 96 percent of their loans were nonperforming. And, on the MacNeil-Lehrer show one night, they asked them did you have any trouble attracting deposits? And, he said no, not at all. He said all he had to do was to give a little higher interest rate than anybody else, as long as he had the sticker on the window that said that these were insured for \$100,000.

I think that was a very unfortunate situation. I think, looking at this whole brokered deposit arrangement is something that maybe the Congress might want to take a hard look at. I would not recommend changing the \$100,000 limit for the individual saver. I think that was tried here, somebody floated that in the administration, and I think it got a lot of people very nervous, and I do not think we want to do that.

Mr. PEASE. Well, OK. I can understand that.

You have mentioned a couple of times with deregulation there has been an explosion of growth in S&L industry. Can you give me any notion at all what percentage or proportion of that growth would have been the result of the brokered deposits?

Mr. BOWSHER. No. I think maybe the FSLIC people might have—the Federal Home Loan people—might have some idea. Right off hand, I do not.

Mr. PEASE. I see.

Thank you, very much.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Dorgan will inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

I just have two questions.

First, you indicated in your statement that the Genesis of part of this problem was when the Congress expanded the powers of the savings and loans, and some wheeler-dealers, to use your term, got involved in the industry.

I notice in December when there was a fury of activity to move some of these savings and loans to different owners. Some of the names that crept up in the press reports of those who were new purchasers and who were recipients of the deals were people I would call wheeler-dealers. Is that your observation? Does that concern you?

Mr. BOWSHER. It does concern us that you see some people with some of the same backgrounds, in other words developers and people who are doing highly leveraged deals on Wall Street and things like that, who have become the new owners. That is correct.

Mr. DORGAN. Let me ask you a second question. We are moving some institutions almost risk-free into the hands of some people—the classic wheeler-dealers in this country. They are stacking property upon property, and hiring incompetent people to run them. That does concern me.

While not a central piece of the puzzle, the inheritance of greater risk by the savings and loans is troublesome. It was something I did not vote for; I voted against the inheritance of greater risk.

I just finished reading a book describing the savings and loans involvement in the purchase of junk bonds. Some people say if you take a look at the pie chart and find out what quantity of junk bonds has been purchased by savings and loans it is not very big. They say, I think, 8 or 10 percent.

I have been told that the bulk of the junk bonds owned in the thrift industry are owned by 10 savings and loans. And, I had asked your organization if I could get a list of the savings and loans. Is that available, do you know? Is there a way for me to track that down?

Mr. BOWSHER. Yes, I think it would be best to ask the Federal Home Loan Bank Board for that information. There is no question that there is a high concentration of these, in a few S&L's, and I think, again, that is a potential danger for the future, especially if you have an economic downturn at any time.

Mr. DORGAN. It is the assumption of greater risk by institutions who are purchasing these. If we run into an economic downturn, and if high concentrations of junk bonds are in a couple of thrifts, once again the taxpayers will be ones that bail them out for that extraordinary risk.

Thank you, very much for those answers. I will cut short my questioning in the interest of time, Mr. Chairman.

Chairman ROSTENKOWSKI. Are there any further questions?

Thank you, very much Mr. Bowsher, Mr. Fogel, Mr. Wolf.

For the information of the committee members, it is the intention of the Chair to work through lunch.

[Pause.]

We will begin the testimony with Mr. Seidman, the Chairman of the Federal Deposit Insurance Corporation, and then followed by Mr. Wall, the Chairman of the Federal Home Loan Bank Board, who is accompanied by Mr. White and Mr. Martin, as I understand it. Welcome to the committee, gentlemen. It is always nice to have you back with us.

Mr. Seidman, if you would like to proceed, I will make the observation first that your entire testimony will be included in the record. If you care to summarize, please feel free to do so.

STATEMENTS OF HON. L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman.
I will try to be brief.

Mr. Chairman and members of the committee, I am pleased to be able to testify today concerning the problems of the saving and loan industry and the Federal Saving and Loan Insurance Corporation.

The Federal Deposit Insurance Corporation believes that President Bush's recently announced reform plan for the savings and loan industry generally is a sound proposal. It provides for prompt action to resolve the S&L situation, and proposes reforms designed to make the Federal Deposit Insurance system cost effective.

The FDIC has had firsthand experience dealing with many of the problems similar to those faced by the thrifts and by FSLIC. In 1988 alone, the FDIC dealt with \$80 billion of problem bank assets, more than the total assets handled during its first 50 years of existence.

Because of these problems and our concerns over the high costs of providing deposit insurance, the FDIC undertook a year-long review of ways to improve the deposit insurance system. The product of that review—our recently released study, "Deposit Insurance for the 90's: Meeting the Challenge"—recommends reforms to the deposit insurance system.

As part of that review, we also evaluated the size and estimated costs of the thrift problem, and analyzed alternative funding sources. And, I am submitting the executive summary of that study for the record.

I now would like to turn to the S&L problem.

In order to estimate fully the budgetary implications of the thrift problem ascertaining the size of the insurance loss is critical. At the beginning of 1988, there were approximately 500 GAAP insolvent thrifts with assets over \$200 billion. During 1988, the Federal Home Loan Bank Board took action on more than 200 S&L's at a reported cost of over \$39 billion on a present value basis.

We have stated in the past that reliable cost estimates of resolving the insolvent thrifts can be made only through onsite examinations. We are in the process of making such estimates pursuant to the joint oversight effort discussed in detail in my written testimony and provided in the President's plan.

At this time, we believe the Treasury Department's \$90 billion cost estimate is reasonable, providing economic conditions do not worsen, and assuming that the accuracy of the \$39 billion estimated cost of the S&L's handled in 1988.

We understand the General Accounting Office will be releasing a cost analysis of the S&L transactions during 1988. The GAO's report and the completion of onsite examinations will give us further and more definitive information on the size of the S&L problem.

The Bush reform plan financing package has been developed by the Treasury and the Office of Management and Budget, and they are in the best position to comment on it. The plan appears viable, and sound providing for an equitable sharing of the financial burden between the S&L industry and the Treasury.

In particular, the Bush reform plan calls for increased insurance premiums for both banks and S&L's. The increased premiums for the S&L's will be used to partially offset the costs of the industry's problems. The bank's increased premiums will be used to strengthen

the FDIC insurance fund for banks. Both premium increases will add to the general fund revenues for budgetary purposes.

An increase in bank premiums is consistent with the conclusion reached in our study that they be increased to reflect more accurately recent losses experienced by the FDIC fund.

We support the Bush plan proposal to increase the assessment rate for banks from 8.33 basis points to 12, and then to 15 the year after that, and to stay at that rate until the fund reaches the desired level of reserves.

We do not believe these increases will put or pose an undue burden on the banking system.

As to the proposed increased premiums on the thrift industry, that industry should shoulder as much of the burden of its own problems as possible. Increased premiums affect profitability and potentially even solvency. Thus, it is important to levy rates that will leave the S&L industry viable and not drive more institutions into the Federal safety net.

Based on the roughest estimates we have at this time, the proposed increase in thrift premiums does not appear to be unreasonably burdensome.

We would again like to express our appreciation to you and the members of the committee for your efforts in including much-needed-tax incentives to the FDIC assistance transactions in the Technical and Miscellaneous Revenue Act of 1988.

To insure that the FDIC and the overall Federal budget realize the maximum savings benefits from these provisions, we have moved as quickly as possible to implement the changes and educate prospective purchasers of failed banks of the potential benefits. This effort has taken several forms, and is described in detail in our written statement.

As indicated in my testimony before the committee in late January, the FDIC is currently refining its methods for analyzing the effects of the new tax provisions on our transactions and on the overall costs of governmental assistance. We will make a complete report to the committee as soon as we have analyzed enough transactions to provide more reliable information. We hope that will be within 3 or 4 months.

We want to stress that we will use these tax provisions to minimize the Government's total cost of handling failed institutions.

The tax provisions will help to handle the losses that must be absorbed to resolve the S&L and bank case loads. In this regard, the committee should make clear that these provisions also should apply to the newly proposed Reconstruction Trust Corporation, which is part of the President's plan.

We also hope that the committee will extend the application of these provisions beyond the year-end 1989. If not extended, the increased cost will be directly reflected in the increased Treasury expenditures for S&L case resolutions under the Bush reform plan.

In conclusion, I would like to make one point, and that is that under the new Bush plan no resolutions of the insolvent thrift problems, which are now being taken over by the joint task force, can be achieved until the Congress provides funds and guidance.

We would be happy to work with the committee on any aspect of this situation where we may be helpful, and I am pleased to answer any questions you have.

[The statement of L. William Seidman and the executive summary he referred to follow:]

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Good morning, Mr. Chairman and members of the Committee. I am pleased to testify today concerning the problems of the savings and loan ("S&L") industry, and the Federal Savings and Loan Insurance Corporation ("FSLIC").

The Federal Deposit Insurance Corporation ("FDIC") believes President Bush's "Reform Plan for the Savings and Loan Industry" ("Bush Reform Plan"), announced February 6th, generally is a sound proposal. It provides for prompt action to resolve the S&L situation and proposes structural and regulatory reforms designed to make the federal deposit insurance system cost-effective. These changes will help prevent a recurrence of the factors that led to this most costly problem.

BACKGROUND

As the insurer of bank depositors, the FDIC has been concerned that the thrift industry's problems pose a threat to the profitability -- and potentially even the stability -- of many banks.

The FDIC has had firsthand experience dealing with many problems similar to those faced by the thrifts and the FSLIC. These include high and volatile interest rates, increased competition from nonbank providers of financial services, a boom-to-bust economy in the Southwest, and fraud and insider abuse.

These adverse conditions have contributed to the record number of bank failures over the past several years. In 1988 alone, the FDIC fund dealt with \$80 billion of problem bank assets -- more than the combined total of assets handled during its first fifty years. As a result, the insurance fund declined from over \$18 billion to approximately \$14 billion -- our first operating loss ever.

Concern over the high cost of providing deposit insurance led the FDIC to undertake a year-long review of ways to improve the current deposit insurance system. Our recently released study, Deposit Insurance for the Nineties: Meeting the Challenge, contains recommendations for reforming the deposit insurance system and provides an outline for a restructured federal deposit insurance system. I would like to submit the executive summary of our study for the record. As part of our review, we studied the size and estimated cost of the thrift problem, and analyzed alternative funding sources.

I would like to turn now to the S&L problem.

BUDGETARY IMPACT OF PROBLEM

Size of the problem. In order to estimate fully the budgetary implications of the thrift problem, ascertaining the size of the insurance loss is critical. At the beginning of 1988, there were approximately 500 insolvent thrifts under generally accepted accounting principles ("GAAP") with assets over \$200 billion. During 1988, the Federal Home Loan Bank Board ("FHLBB") took action on more than 200 S&Ls at a reported cost of over \$39 billion on a present value basis. We understand that the General Accounting Office ("GAO") soon will release a cost analysis of S&L transactions during 1988.

As of the end of the third quarter of 1988, there were about 220 thrifts that were insolvent under regulatory accounting principles ("RAP"), not including those thrifts handled by the FHLBB in 1988, and another 119 GAAP insolvent thrifts. Our latest estimates suggest that current operating losses at these

RAP and GAAP insolvent S&Ls are about \$200 million per month. That figure will be higher if S&Ls experience deposit outflows, as they have recently, and must fund with higher cost deposits.

We have stated in the past that reliable cost estimates of resolving the insolvent S&Ls can be made only through detailed on-site examinations. We are in the process of making such estimates pursuant to the joint oversight effort discussed below. Our best estimates at this time are in the same range as the Treasury Department's estimated cost of \$90 billion.

Bush Reform Plan financing proposal. Regarding the financing package, the Treasury Department and the Office of Management and Budget are its architects, and are in the best position to comment on its efficacy. From our viewpoint, the Plan appears viable and sound. The Bush Reform Plan provides for an equitable sharing of the financial burden between the S&L industry and the Treasury.

Appropriately, banks are not required to pay for the S&L losses. While the Plan places a heavy burden on the S&L industry to pay for its problems, the S&L industry should be required to bear as much of the cost as possible without jeopardizing their sound institutions.

Ability of banks and S&Ls to pay increased premiums. The Bush Reform Plan calls for increased insurance premiums for both banks and S&Ls. The increased premiums for the S&Ls will be used to partially offset the cost of that industry's problems. The banks' increased premiums will be used to strengthen the FDIC insurance fund. Both premium increases will add to general federal revenues for budgetary purposes.

In our recently released study on deposit insurance, we concluded that FDIC deposit insurance premiums should be adjusted for the risk and costs incurred by the insurance fund. The FDIC spent \$7 billion dollars last year, and our fund declined by about \$4 billion, or over 20%. Our fund's reserves at year-end will be reduced to 83 cents per \$100 of insured deposits, well below desired levels. Without regard to the S&L industry problems, the FDIC study recommended that bank premium rates be increased to reflect more accurately recent loss experience of the FDIC fund.

The Bush Reform Plan calls for such an increase -- and we support this proposal. Raising bank premiums from their current level of 8.33 basis points to 12 basis points next year, and then 15 basis points the year after, is reasonable. We estimate going to 12 basis points will increase premiums about \$700 million, and that 15 basis point will bring in almost \$600 million more.

The increase in premium expenses translates to about 2.1 percent and 3.8 percent of pre-tax earnings at 12 and 15 basis points, respectively. To some extent, this increase probably could be offset by repricing of services, but the ability to do this is constrained by today's competitive market place. Assuming that all the increase resulted in earnings reductions, we estimate that fewer than 100 institutions out of over 13,000 that are now profitable would be made unprofitable.

The majority of the banks that would suffer the most significant decline in profitability from higher assessments are located in the Southwest and Midwest regions, the two regions that have experienced the greatest difficulties during this decade.

Given recent FDIC loss experience, the increases are consistent with our study's conclusions and should not pose an unreasonable burden to the banking system. Importantly, the revenues generated from these premiums will go solely to build the FDIC fund.

Under the Bush Reform Plan, once the FDIC insurance fund moves up from .8 to 1.25 percent of insured deposits, banks can expect premium rebates. Our preliminary estimate is that rebates could begin as early as the mid-1990s under the President's plan.

We recently completed an evaluation of the rebates the FDIC paid from 1950 through the early eighties. We added all rebates from that period back into our fund and applied the yield we would have earned on those funds. We discovered that, if no rebates had been paid during that time, the FDIC today would have another \$26 billion in its insurance fund.

This indicates that the current rate of 8 basis points was more than sufficient to meet costs if no rebates had been paid. Thus, a return to lower premiums may be indicated at some future date.

As to the proposed increased premiums on the thrift industry, the thrift industry should shoulder as much of the burden of the industry's problems as possible. Since increased premiums affect profitability, and potentially even solvency, it is important to the insurer to levy rates that will leave the S&L industry viable -- and not drive more institutions into the federal safety net.

Based on the rough estimates we have at this time, increasing the thrift deposit insurance premiums from 20.833 basis points to 23 basis points does not appear unreasonable. This increase of just over 2 basis points will have little additional negative impact on thrift earnings. The many factors that affect the future profitability of the thrift industry make a judgment in this area uncertain, but it appears this increase would not impose a life-threatening burden on the industry. We are in the process of conducting further analysis on this subject using both our resources and industry studies.

FDIC AND FSLIC TAX PROVISIONS

The Tax Reform Act of 1986 significantly increased the tax burden on our nation's commercial banks, especially through limitations on deducting both bad debt reserves and interest on debt used to purchase tax-exempt obligations. While certain provisions in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") will benefit the industry as a whole, they are unlikely to reduce this increased burden to an appreciable extent.

TAMRA. As you, Mr. Chairman, and the members of your Committee are well aware, TAMRA extended but reduced the tax incentives provided to FSLIC-assisted transactions. At the same time, it extended limited tax incentives to FDIC-assisted transactions to provide parity with FSLIC transactions. We again would like to express appreciation to you and the Committee for your efforts in including these much-needed FDIC-related provisions in that legislation.

We want to stress that we will use these tax provisions to minimize the government's total cost of handling failing institutions. When the FDIC determines whether the most cost-effective solution is an assisted transaction or the liquidation of the problem institution, we will consider both the direct cost to the FDIC and our best estimate of the tax expenditure to the federal government.

These provisions will help to handle the massive amounts of losses that must be absorbed to resolve the S&L and bank caseloads. In this regard, the Committee needs to make clear that these provisions apply to assistance provided through the Reconstruction Trust Corporation, proposed as part of the Bush Reform Plan. We also hope the Committee will extend the applicability of these provisions beyond year-end 1989. If not extended, the increased cost will be directly reflected in increased Treasury expenditures for S&L case resolutions under the Bush Reform Plan.

TAMRA, as it relates to FDIC transactions, is important for two reasons. First, it clarifies the tax treatment of FDIC assistance transactions. Prior to the passage of TAMRA, there was significant confusion concerning the proper tax treatment of these transactions. The confusion resulted in a double negative from the standpoint of the federal budget. The FDIC enjoyed no reduction of its assistance costs because bidders minimized the value of tax attributes because of the uncertain tax consequences of such transactions. At the same time, we believe taxpayers took aggressive reporting positions following these transactions in a way that resulted in reduced tax revenues. The clarifications that have been provided through TAMRA go a long way toward avoiding this double negative result, and minimize the government's total cost of handling failed institutions.

Second, the FDIC now has an opportunity to receive the maximum benefit from the tax attributes of assistance transactions, and thereby minimize the government's overall assistance costs. This will reduce the "on-budget" cost of FDIC-assisted transactions, and have a positive effect on the deficit in the current budgetary year. Of course, there also is an offsetting revenue cost associated with these transactions.

In addition to this tax-related reduction in FDIC assistance cost, there is another cost savings that we expect to realize as a consequence of the TAMRA provisions. Specifically, we believe that we will be able to complete more "whole bank" transactions. In these transactions, the purchasers of failed banks acquire all or most of the banks' assets, including the nonperforming or troubled assets. Such transactions differ from "clean bank" transactions where the purchaser takes only the good assets. Where we are able to do a whole bank transaction, as compared with a clean bank transaction, the FDIC's net cost is less. This savings results from a higher asset realization through management of the troubled assets by the purchaser, rather than by the FDIC.

Implementation steps. To ensure that the FDIC and the overall federal budget realize the maximum savings benefits from the TAMRA provisions, we have moved as quickly as possible to implement the tax law changes and educate prospective failed bank purchasers of their benefits. This effort has taken several forms.

First, we are conducting internal seminars for FDIC employees on the operation of the provisions. Second, we are working with the Internal Revenue Service to further clarify the new provisions so they operate in an efficient manner. Third, we are sponsoring extensive seminars throughout the country for potential bidders concerning the nature of the new provisions and the methods by which the FDIC is implementing them. Fourth, we are providing notices to potential bidders for failed banks describing the operation of the tax changes and the impact they should have on the need for FDIC assistance. Fifth, we are providing information with respect to each failed bank as part of the initial bid information that analyzes the impact of the tax provisions. And sixth, trained tax coordinators will be present at bid meetings to make sure all tax-related considerations are understood.

Cost savings. As indicated during my testimony before the Committee in late January, the FDIC is currently refining its methods for analyzing the effect of the TAMRA tax provisions on our transactions, and on the overall cost of government assistance. We will make a complete report to the Committee as soon as we have analyzed enough transactions to provide more reliable information.

Although we may not yet be realizing the maximum benefits from the changes in the tax law, we believe that the implementation steps noted above -- most significantly the education of bidders concerning the value of the tax provisions -- will result in increased competition and a maximization of assistance savings in the near future.

As stated above, we are working closely with the Internal Revenue Service to clarify certain provisions applicable to FDIC-assisted transactions. The IRS recently has confirmed that individual certification is a statutory requirement necessary for the purchaser of a failed bank to obtain the various tax attributes of the acquired bank. We believe this clarification will give us increased leverage in achieving appropriate savings by withholding certification if the assuming bank is not properly valuing the tax benefits.

We will continue to employ these tax provisions in a reasonable and cost-effective manner, and we respectfully urge the Committee to extend these provisions into 1990.

INTERAGENCY OVERSIGHT EFFORT

I would now like to turn to the interagency oversight effort underway to deal with the currently RAP insolvent S&Ls.

As part of the Bush Reform Plan, the President recently requested that the FDIC lead a joint effort to evaluate and oversee most of the RAP insolvent thrifts. In addition to the FDIC and the FSLIC, the Federal Home Loan Bank Board, the Federal Reserve, and the Office of the Comptroller of the Currency are participating in this interagency initiative.

The purpose of this interagency effort is to limit the growth of problems in our nation's insolvent thrifts until a comprehensive reform of the deposit insurance system, and the necessary funding, are authorized by the Congress. Insured deposits will remain fully protected throughout this process.

In the last two weeks a joint task force of regulators, led by the FDIC, took control of 36 of the insolvent thrifts. We expect to assume oversight of almost 200 other RAP insolvent thrifts in the next four to six weeks.

The FSLIC has contracted with the FDIC to take control of these institutions that are being placed in conservatorship or receivership. That means the FDIC, with the help of other regulators, will oversee operations of the insolvent thrifts. Managements of the various institutions are subject to the regulators' authority. From the customer's perspective, however, the only visible difference will be a few more people in the institution's offices. Day-to-day operations will continue to preserve basic services to deposit and loan customers.

One of the first priorities of these oversight efforts will be to evaluate the losses at each institution. Such on-site examinations are necessary to produce accurate estimates of the cost of the thrift problem. Once our estimates are completed and GAO has issued its report on the cost of FSLIC's 1988 deals, the total cost of this problem can be determined.

Another top priority is to identify and stop any abuse, waste, or fraud that may be present. A further priority will be to prepare a business plan for the institution and seek cost reduction through consolidations and more efficient operations.

While in control of these institutions, we will seek to stop any unsafe or unsound practices. We will limit their growth, and downsize them through asset liquidations where possible. However, we will avoid firesales of assets and emphasize the need to sell at values that reflect current appraised values.

Finally, we will develop longer-term solutions to these problems. Our staff will recommend different approaches -- from liquidating the institutions to selling them to qualified purchasers. But our current job is a holding action only. We will not issue notes or enter into income maintenance agreements.

The FDIC has established four task groups to address these responsibilities. These task groups are designed to ensure stable operations in the insolvent thrifts and to evaluate options for permanently resolving their insolvency once funding is approved by Congress.

One of our most important task groups is our new Fraud Squad. As President Bush has said, "unconscionable risk-taking, fraud and outright criminality have also been factors [in the thrift problem]." Investigators assigned to this Fraud Squad will constitute a mobile unit. Whenever our on-site teams discover evidence that fraud or insider abuse may have occurred, the Squad will be sent to conduct a full-scale investigation. This includes looking for ways to get back misappropriated assets when possible, and helping send some to jail when appropriate.

Our three other task groups have separate but complementary assignments.

Our Oversight and Evaluation task group will examine these institutions' condition, provide guidance to these institutions, and take steps to reduce operating costs where possible.

Our Planning and Restructuring task group will recommend steps to restructure and consolidate institutions where appropriate.

And our Transaction and Acquisition task group will begin the process of seeking out buyers for institutions, real estate and other assets. We will seek to reach agreements with purchasers subject to resources being made available to provide assistance.

The FDIC and the FHLBB have agreed that, until the agencies review the status of the insolvent thrift institutions placed under joint regulatory oversight, only cash assistance transactions will be undertaken by the FSLIC.

We also must note that these additional responsibilities in addressing the S&L situation will place a strain on FDIC resources. We are dedicated to this new task and will strive for success, but we do expect to experience growing pains and recognize our need to climb a learning curve in the process.

RECOMMENDED DEPOSIT INSURANCE REFORMS

Any legislated resolution of the FSLIC problem, in addition to providing appropriate funding, should reform the system to protect against recurrence of the problems that led to the current S&L situation. As mentioned above, detailed recommendations for improvements to the system are contained in the recent FDIC study. However, I would like to summarize some of the most important concepts.

One of the fundamental changes recommended in our study is that the federal insurer be allowed to operate as much as possible like an independent private insurer. This principle is central to improving the system. To maintain adequate resources, the insurer must have additional controls over revenues, including the ability to adjust insurance premiums paid by insured institutions and to require an entrance fee from those newly obtaining insurance. The insurer also must be able to control costs. This necessitates the ability to set standards for insurability for all insured institutions and to promptly terminate insurance privileges when an institution is operating in an unsafe manner. The Bush Reform Plan, for the most part, includes these important changes to the operating structure of the federal deposit insurance system for S&Ls.

To accomplish private insurer status, the FSLIC and FDIC also should be as financially, operationally, and organizationally independent as possible. To ensure political independence, the insurer should continue to be funded by premiums paid by the insured institutions. It should have a budget separate from the general federal budget and should not be allowed to obligate general federal revenues. The insurer also should remain independent from the Congressional appropriations process. The insurer should remain accountable to Congress on an annual basis. The insurer's ability to issue notes or like obligations should be restricted as provided in the Bush Reform Plan.

CONCLUSIONS

We believe the Bush Reform Plan is a generally sound proposal, and hope Congress acts on it promptly. Congressional funding will be necessary for a cost-effective solution to these problems. Any legislated resolution of the S&L situation should improve the federal deposit insurance system to protect against a recurrence of existing problems.

-8-

We appreciate the passage of the recent amendments to the tax laws concerning FDIC-assisted transactions, and are working to maximize our savings for the government as a result of those amendments.

We would be happy to work with the Committee on any aspect of the S&L situation where we may be helpful. I would be pleased, at this time, to answer any questions the Committee may have.

EXECUTIVE SUMMARY

This report, "Deposit Insurance for the Nineties: Meeting the Challenge," is a review of the federal deposit insurance system. The FDIC undertook this review because of a growing realization that deposit insurance requires some fundamental changes if it is to continue to serve the purposes for which Congress created it over 55 years ago.

Virtually all agree that deposit insurance has accomplished its basic goals of maintaining stability and confidence in the banking system, and that these goals are vital to our Nation's economy. Deposit insurance has helped ensure a sound banking system by providing a safe haven for people's money, thereby instilling confidence and preventing panic-driven bank runs:

Our Nation must have a sound banking system because that system is at the very heart of our economy. Banks are essential to the payments mechanism, to the control of the money supply, and to the provision of financial intermediation--the bringing together of borrowers and savers.

Deposit insurance also has helped maintain a flexible and responsive banking system by facilitating a decentralized structure where new and smaller banks can compete against larger institutions.

-2-

While deposit insurance has provided many social and economic benefits, the events of the last decade have brought into clear focus that the current deposit insurance system has created potentially staggering costs.

Simply put, federal deposit insurance allows thousands of institutions to leverage their capital with government-backed funds--deposits. Imprudent decisions by only a relative handful of financial institutions can generate enormous losses for the deposit insurer. Strong supervision and market discipline are critical to keeping in check the risk-taking incentive created by this structure.

Deposit insurance should be self-funding--premiums collected and invested should be sufficient to cover costs of problems when they develop. The system worked well in the days of limited financial institution competition and relatively stable economies and interest rates--before technological revolutions and global competition required deregulation. Now, the business of deposit insurer is more complex and, often, more costly.

For 1988 alone the FDIC will show a 15 to 20 percent reduction in its fund--its first operating loss ever. While the FDIC expects to make an operating profit in 1989, changes are necessary to ensure sound future operations.

The potential costs of deposit insurance are even more obvious in our sister insurance agency, the Federal Savings and Loan Insurance Corporation

-3-

(FSLIC), where hundreds of thrifts are insolvent and even the most optimistic resolution costs greatly exceed the fund's and the thrift industry's resources.

Our Study looks at the FDIC's recent experience, and that of FSLIC, and explores how to improve deposit insurance so that it can be made a cost-effective system for the Nineties.

The FDIC Study concludes that the following principles are required to provide a sound deposit insurance system for the Nineties.

First, deposit insurers should be made as financially and organizationally independent as possible. The insurer must be sensitive to the concerns of chartering authorities and the industry it insures, but it must have the freedom to control costs. To ensure political independence, the insurer should be self-funded. It should have a budget separate from the general federal budget and the insurer should not be allowed to obligate federal revenues. The insurer also should be independent from the Congressional appropriations process. The insurer should remain accountable to Congress and the Administration, yet remain free from annual budgetary controls.

Second, the federal deposit insurer must be given certain basic tools that would be available to a private insurer to control costs. These include:

- o The ability to promptly terminate insurance privileges when an institution is operating in an unsafe manner.

-4-

- o The ability to set standards for insurability by a federal deposit insurance system.
- o The authority to examine and assess risk at all insured institutions.

Third, to ensure adequate resources, the insurer should have additional controls over its revenues:

- o The power to adjust insurance premiums, within prescribed limits, to reflect experience and costs on a continuing basis.
- o The power to assess borrowings that are secured by assets--assets that otherwise would be available to the insurer in the event of failure.
- o The power to require that institutions obtaining federal insurance pay an entrance fee sufficient to maintain the ratio between the insurance fund and insured deposits.
- o The power to borrow from both the Department of the Treasury and the Federal Reserve.
- o The power to require all federally insured institutions owned by a common parent to indemnify the insurer against any losses resulting from the failure of an affiliated bank. The FDIC prefers this option to an earlier proposal that would have required the consolidation of affiliated banks.

-5-

The Study also offers other recommendations: First, the FDIC seeks clear authority to distinguish between depositor and nondepositor claims in failure-resolution transactions. This approach differs from previous calls for depositor preference statutes in that nondeposit creditors would maintain their pro rata rights to the assets of the failed institution. Such creditors may have to wait along with the FDIC for assets to be liquidated, while depositor liabilities are transferred to another institution.

Second, the FDIC continues to advocate moving toward a system where nontraditional activities take place outside the bank in subsidiaries using excess bank capital or in separately capitalized affiliates. Under such conditions, the FDIC recommends that banking organizations be allowed to become involved in a wide variety of activities.

Third, the experience of the past several years demonstrates that regulatory agencies must work to improve their supervisory capabilities. Regulatory agencies must maintain highly skilled, professional staffs. In addition, regulators must improve their understanding of risk diversification and the competitive and economic environments in which their banks operate. New regulatory methods of anticipating potential problems are suggested. In this regard, the FDIC plans to work with other regulators, industry representatives and academics to develop regional oversight committees.

The Study reviewed other proposals for improvements to the system. A fundamental conclusion is that proposals to increase so-called depositor discipline by curtailing insurance protection should be rejected. The FDIC view is that increasing pressure on depositors to control bank risk in a

-6-

rational manner is impractical. Most depositors looking for safe, short-term investments cannot be expected to know the true condition of a financial institution. That is challenging enough for examiners and analysts who have regular access to bank management and records. Most importantly, attempts to increase depositor discipline would increase the threat of financial instability and bank runs, and undermine the very reason deposit insurance was deemed necessary.

The FDIC also rejects so-called "narrow-bank" proposals that would restrict depository institutions to only the most liquid and safe investments. Forcing lending operations out of banks, which would be required by these proposals, would be inefficient in view of banks' considerable expertise in financial intermediation. Further, in order to maintain stable economic growth, our government would need to develop other approaches to ensure that short-term, risk averse, investors can be brought together with borrowers with long-term and complex needs for funds.

While the FDIC rejects decreasing depositor protection, it cannot support proposals to increase depositor protection to 100 percent. FDIC experience and recent studies show that depositors remain fairly sensitive to bank risk-taking. To completely eliminate such constraints would increase the potential risk to the insurer.

Arguments to raise or lower deposit protection also stem from the perceived inequity in the way large banks are handled relative to small banks. The FDIC acknowledges that some inequity does exist. Uninsured depositors in very small banks sometimes bear somewhat greater risk of loss

-7-

than those in large banks. Under current law, the FDIC must determine that protecting uninsured depositors is cost-effective in failure resolutions or that factors exist that make it essential to protect uninsured depositors.

Experience shows that protecting all depositors is more likely to be cost-effective in larger banks because of greater relative franchise value maintained in large banks.

The FDIC can deviate from the cost test on rare occasions when a bank is found to be essential to its community--but such essentiality considerations are more likely to exist with larger banks than smaller institutions. To address this inequity, the FDIC will continue its practice of trying to avoid depositor losses whenever possible. In recent years over 99 percent of all deposits in failed banks have received full protection.

The study concludes that, on balance, the current deposit insurance system provides an appropriate balance between depositor discipline and financial stability. Our view is that risk-taking incentives created by deposit insurance can be controlled through ensuring market discipline by investors and management, adequate capital requirements, improved regulatory structure, and strengthened supervisory process.

While studying deposit insurance, the FDIC reviewed the problems facing its sister insurance agency--the FSLIC. The most obvious problem is to provide funding so that hundreds of insolvent institutions can be resolved. It appears the federal government will have to absorb much of this cost, since the thrift industry is not strong enough to shoulder the burden alone.

-8-

Moreover, the FDIC finds no reason for the banks to be singled out to pay for the thrift industry's problems. The Study reviews proposals for ameliorating the impact on the federal deficit of the costs of returning FSLIC to solvency.

Equally as important as arranging for adequate funding is taking steps to ensure current losses do not recur. Many of the recommendations for deposit insurance reform discussed earlier are necessary for a viable and responsive insurance system. There are a variety of alternatives for implementing these reforms for FSLIC. The study recommends three possible options that satisfy the requirements set forth above. These options can be called: (A) A new stand-alone FSLIC; (B) An administrative merger of FSLIC into FDIC; and (C) Comprehensive reform of the thrift regulatory structure. (See attached Appendix A.) The FDIC favors option A.

A stand-alone FSLIC envisions the creation of a separate FSLIC that is independent of the Federal Home Loan Bank Board (FHLBB). The FHLBB would continue to charter and supervise federal thrift institutions and would operate both the Federal Home Loan Bank System and the Federal Home Loan Mortgage Corporation (Freddie Mac). The newly-separated FSLIC would directly supervise all state-chartered thrifts and be responsible for all liquidation activities related to FSLIC-insured institutions. The FSLIC would not be subject to the appropriations process. The district Federal Home Loan Banks would no longer examine or supervise thrifts. Their role would be confined to providing liquidity for institutions meeting housing-related criteria. System membership would be available to any depository institution meeting these criteria.

The second option is an administrative merger of FSLIC into FDIC. There would be common management and an administrative Board over separate FDIC and FSLIC funds. The new FDIC would supervise state-chartered thrifts and state-chartered banks that are not members of the Federal Reserve System and would perform all liquidation activities for insured banks and thrifts.

The third option calls for comprehensive reform of the deposit insurance regulatory structure. The administrative functions of the FSLIC and the FDIC would be merged into a new corporation. The Office of the Comptroller of the Currency (OCC) would assume responsibility for chartering and supervising federal thrifts, and the Federal Reserve Board would supervise thrift holding companies. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddie Mac, under the umbrella of the Department of Housing and Urban Development or the Federal Reserve Board.

These are the major conclusions and recommendations in our Study. A summary of the discussion in each chapter follows.

Introduction

Chapter 1 provides a brief introduction to the FDIC's examination of our federal deposit insurance system. Concerns about the continued viability of the deposit insurance system stem from the economic, technological and regulatory changes that have affected our economy's financial markets over the past decade. Deposit insurance reform was examined at length following the

-10-

financial deregulation of the early 1980s. In general, these studies found that the regulators' ability to control excessive risk-taking had been hampered by the changing financial environment.

Today, deposit insurance reform continues to receive attention. Proposals to modify the system range from a major scaling back of insurance guarantees and greater depositor discipline, to increased emphasis on capital requirements, supervision and timely closure of insolvent institutions. This Study examines the current system and recommends changes to enable the deposit insurance system to meet the challenges ahead.

Framework for Analyzing Deposit Insurance Reform

Chapter 2 reviews the benefits and costs associated with the provision of deposit insurance and provides a framework for analyzing deposit insurance reform. Deposit insurance promotes financial stability by preventing bank runs. However, deposit insurance also may create an incentive for banks to take excessive risks. (While the owners of insured deposits have little incentive to participate in bank runs, they also have little incentive to pay attention to the riskiness of their bank's activities.) These two fundamental effects of deposit insurance, and the relative importance one may attach to them, underlie all of the numerous proposals to replace, curtail, or otherwise reform deposit insurance.

Comprehensive deposit insurance reform tends to be favored by those who take the view that the benefits associated with the prevention of bank runs

are less important than the costs associated with the risk-taking incentives created by deposit insurance; or that the costs associated with bank runs can be controlled adequately by alternatives to deposit insurance.

Proponents of more modest reform take the view that the more significant costs are associated with bank runs, and that risk-taking incentives created by deposit insurance can be controlled adequately through market mechanisms, capital requirements and the supervisory process. The FDIC's view falls into this category.

Deposit Insurance Pricing

In Chapter 3, "Deposit Insurance Pricing," problems associated with the current flat-rate pricing scheme and the feasibility of implementing a system of explicit risk-related premiums are addressed. In the absence of regulation and supervision, flat-rate premiums provide incentives for excessive risk-taking and inequitably distribute the burden of insurance losses among banks. If unchecked, these perverse incentives may lead to an excessively risky banking system and undermine the viability of the deposit insurance system.

In practice, this incentive toward excessive risk-taking is counterbalanced, to some extent, by existing market discipline and through regulation and supervision. Federal and state regulators periodically examine banks to determine if they are operating in an unsafe or unsound manner. Undesirable behavior is penalized through the issuance of cease-and-desist

-12-

orders or the imposition of other sanctions. In addition, laws and regulations limit the kinds of activities that insured institutions may engage in and set minimum capital requirements. To the extent that these implicit costs vary with the riskiness of the bank, they function as a system of risk-related premiums and constrain risk-taking.

The major question is whether an explicit risk-related pricing formula could be established that would be an improvement over the current system of flat-rate premiums, regulations and supervisory sanctions. In assessing this question, a number of risk-related pricing schemes are reviewed. Risk-related schemes that rely on market information to assess bank risk generally suffer from problems in obtaining accurate market information for all insured institutions. In the absence of a market-based approach, the FDIC would be left with the task of administratively determining an explicit pricing formula. Thus far, it has not been possible to establish a satisfactory pricing formula based on ex ante or before-the-fact measures of risk.

It does appear feasible to establish a general pricing formula that would complement the existing supervisory sanctions, based on ex post or after-the-fact measures of risk. The adoption of such a system, with only modest premium differentials at first, will not eliminate entirely the incentive for banks to take excessive risks. However, it may offer somewhat greater deterrence, require regulators to assess risks more diligently, and allocate the costs of insurance more equitably among banks.

While a more equitable distribution of the insurance burden is desirable, an even more critical concern is to ensure adequate funding for the

insurance agency. An adequately financed deposit insurance system is important for three reasons. First, an insolvent insurer has similar incentives to take excessive risks as does the management of an insolvent insured depository; this helps explain actions of FSLIC in the early 1980s in encouraging thrifts to grow out of their problems by further leveraging nonexistent capital. Second, the passing of expenses and losses to the industry on a more current basis will provide greater incentives for the development of self-regulation and mutual risk-reduction measures. Finally, Congress and the public have every right to have assurances that the need for taxpayer money in the future will be minimal.

To help ensure adequate funding for the insurer over the long run, several recommendations are presented in Chapter 8. First, total assessments to the industry should be based on a modified three-year average of actual loss and expense accruals. Limits may be appropriate for year-to-year changes in assessments and for the maximum level of assessments.

Second, the assessment base should be expanded to include secured borrowings. While there are good arguments for also including foreign deposits in the assessment base, there is sufficient uncertainty with respect to certain issues that no recommendation is made at this time.

Third, the rebate system should be based solely on the relationship of the fund to the assessment base. Rebates would begin when the ratio of the fund to the assessment base exceeded a threshold level.

Fourth, the FDIC should be given direct authority to borrow from both the Department of the Treasury and the Federal Reserve System.

Finally, operating institutions obtaining FDIC insurance should pay an entrance fee sufficient to maintain the ratio of the fund to the assessment base at a constant level. This could be accomplished through a one-time charge or a deposit that is taken into the fund over time.

Market Mechanisms for Controlling Risk

Chapter 4, "Market Mechanisms for Controlling Risk," examines market discipline as a form of risk control in banking. Market mechanisms for controlling risk are considered under four broad categories: insurance coverage (depositor discipline), disclosure, capital standards, and the priority of claims in bank liquidation (depositor preference and nondepositor discipline).

Based on the premise that de facto 100 percent coverage has rendered depositor discipline ineffective, some have argued for explicit, 100 percent coverage of deposits, regardless of size. Full coverage, it is argued, could result in greater stability with respect to bank runs, more equity in the system, and also could allow for a more consistent and orderly resolution of bank failures. Moreover, 100 percent coverage may facilitate certain changes in failure-resolution methods that, according to proponents, would increase the effective level of market discipline. The major problem with this argument is the assumption that depositor discipline is completely absent from

the current environment. FDIC experience suggests otherwise and recent studies also contradict this, suggesting that CD markets are fairly sensitive to bank-specific risk and act to constrain banks wishing to pursue riskier activities.

Others have argued that there should be greater depositor discipline; that deposit insurance coverage levels perhaps should be reduced from the present \$100,000 level; and that in order to control bank risk-taking, uninsured deposits should be exposed to losses in bank failures. However, the problem with depositor discipline is the same one that existed in the 1930s, which led to the creation of the federal deposit insurance system: depositor discipline can lead to destabilizing bank runs.

What proponents of greater depositor discipline often overlook is that market discipline presently exists in many important respects. Bank stockholders, bank management and bank holding company creditors almost always suffer losses when a bank fails. Each of these groups has an incentive to control a bank's risk-taking. Uninsured depositors and creditors also exert some control over bank risk-taking, since they are not assured of complete protection in a bank failure.

Chapter 4 concludes that existing levels of market discipline appear adequate to control risk-taking by healthy banks. The Study recommends against any change to the \$100,000 limit for individual deposit accounts. Limits to insurance coverage on brokered deposits or restrictions on the rates payable for insured brokered funds also are viewed as unnecessary. However, market discipline cannot be relied on to control risk-taking in problem

institutions. As a bank nears insolvency the incentive for self-preservation may lead unprotected creditors and bank management to encourage the very risk-taking that is viewed as imprudent when the bank is healthy. As a bank's condition deteriorates, less reliance can be placed on market mechanisms and more reliance must be placed on the supervisory process.

Supervision

In addition to market discipline, supervision is the other major vehicle for controlling bank risk-taking. Rather than diminish its role, deregulation and other changes in financial markets have made the supervisory role even more critical. In Chapter 5, "Supervision," the role and effectiveness of the supervisory process is examined and recommendations for reform are put forth. Three major areas of the supervisory program are reviewed: the examination program, enforcement authority, and the applications process.

The examination program is the primary mechanism for monitoring the risk of individual institutions and for implementing necessary corrective actions. Several areas are identified as needing reemphasis or improvement.

First, because the FDIC's resources are at stake, the authority for the insurer to examine all insured banks needs to be clarified and strengthened.

Second, the regulatory agencies must improve their methods of identifying risk, setting priorities and allocating resources. This

-17-

includes: (a) improved offsite monitoring through continued development of computer-assisted analyses of bank and industry data; (b) development of online information retrieval systems which will allow regulators computer access to at least the top tier of banks and those that exhibit more than normal risk; (c) development of diversification rules and systems and programs for analyses of industry sectors and geographical groupings in a way that will help focus supervision on potential or emerging problems; and (d) coordination of the information-gathering processes to more systematically establish priorities for onsite examinations of banks that still have satisfactory ratings.

Third, federal bank regulatory agencies must reemphasize and develop better ways to work together and streamline the examination process and information flows between agencies. This includes a rejuvenation of the cooperative examination program whereby the FDIC accompanies the OCC and the Federal Reserve Board in examinations of banks, and the consideration of issuing regional supervisory directives, i.e., alerts to examiners and bankers concerning a local or regional problem that need not wait for a nationwide pronouncement from the Washington offices.

Fourth, an effective examination program is dependent on maintaining a staff of highly skilled, experienced and well-compensated professionals. This means avoidance of periodic hiring freezes, maintenance of a benefits package that is competitive with the private sector, and development or acquisition of specialized expertise to deal with new and changing banking activities.

Finally, the supervision program could be further enhanced by establishing regional economic oversight committees comprised of representatives from different supervisory agencies to evaluate levels of risk in their respective areas. These committees would consult with industry and academic representatives and should seek to anticipate adverse economic trends.

When a bank does not operate in a safe-and-sound manner, regulatory authorities must possess the necessary tools to curb improper behavior. While the types of enforcement tools now available to the FDIC are generally adequate, expanding their applicability and streamlining their implementation would be helpful to the enforcement process. Several recommendations are made.

First, termination of federal deposit insurance should be streamlined to take no more than six months. Existing deposits would continue to be insured for a reasonable period following termination.

Second, capital laws or regulations should be rewritten to clarify restrictions that could be imposed on banks with capital levels below minimum standards. These might include suspension of dividends, restrictions on growth and a prohibition on acquisitions.

Controlling and monitoring risk through the supervisory process also could be enhanced by modifications to the applications process. At present, only state nonmember banks are required to apply to the FDIC for entry into the deposit insurance system. National and state member banks receive FDIC membership automatically upon approval of the OCC or the Federal Reserve.

When granting a charter, the chartering authorities should be required to consider the institution's risk to the insurance fund, using standards developed by the insurer.

Forbearance

Not only does deposit insurance reform require decisions on how much authority to grant bank supervisors, it requires decisions on the amount of discretion to be allowed the supervisor in the exercise of that authority. The trade-off between mandatory rules versus supervisory discretion underlies the discussion in Chapter 6 on "Forbearance." This chapter argues that these are circumstances where it may be appropriate for supervisors to exercise discretion in the face of excessive risk exposure by insured depository institutions; mandatory or rigid enforcement rules run the risk of undermining supervisory efforts to control risks. As used in this context, forbearance should be a deliberate act aimed at achieving control of risk, rather than the consequence of inaction or unwillingness to address problem situations. Many forms of forbearance have been successful in controlling risks, promoting sound operations, and limiting loss to the insurance fund. In Chapter 6 it is argued that the ability to exercise discretion is an important and, in fact, a necessary part of the supervisory process.

Failure Resolution

Chapter 7, "Failure Resolution," reviews alternative failure-resolution policies and evaluates their desirability in terms of how well they meet major

policy objectives. As discussed elsewhere, a trade-off exists between the desire to maintain market discipline against bank risk-taking and the need to maintain public confidence and stability in the banking system. There appears to be substantial market discipline against risk-taking by healthy institutions. It is when a bank encounters financial difficulty that market discipline fades and the incentive to take risks becomes significant. These risk-taking incentives in problem institutions mean it is critical to maintain strong and effective supervision, which includes enforcement of appropriate capital standards and a general policy that calls for timely closure of insolvent institutions.

The view that the trade-off between stability (the prevention of bank runs) and depositor discipline must be weighted heavily in favor of stability is the driving force behind the first two recommendations in Chapter 7. First, because market discipline declines as capital levels decline, timely closure of insolvent institutions is a critical element in controlling risk. Further, since loan-loss reserves represent losses that already are anticipated, it should be clarified that chartering authorities should use equity capital rather than a capital measure that includes loan-loss reserves as the appropriate measure for determining solvency. Second, it would be desirable for the FDIC to have clear authority to distinguish between depositor and nondepositor claims in failure-resolution transactions. Such authority would give the FDIC greater flexibility to increase nondepositor discipline against bank risk-taking without risking greater instability in the banking system (through the introduction of greater depositor discipline and the increased possibility of bank runs).

-21-

Other recommendations in Chapter 7 would increase the FDIC's ability to maintain adequate funding against potential future problems. First, since evidence concerning the disposition of failed-bank assets suggests that it is more cost-effective to keep assets in the private sector rather than in a government liquidation, the current policy of passing as many failed-bank assets as possible to the acquiring bank should be maintained. Second, in order to eliminate the problems associated with affiliated banks operating as a single entity in good times, but as separate corporate entities in bad times, all federally insured banks should be required to protect the FDIC against losses in any banks owned by a common parent.

Issues Related to Handling Large-Bank Failures

The open-bank assistance provided to Continental Illinois National Bank and Trust Company in 1984 focused the "too-large-to-fail" discussion on banking and the way the FDIC approaches failing- and failed-bank situations. The FDIC always has handled the failure of larger banks in a way that results in full protection to depositors and other general creditors of the bank; on the other hand, uninsured creditors in smaller banks on occasion have been subjected to loss.

Since 1951, the FDIC has followed a set of rules that has forced identification of situations that are handled outside of normal criteria. Specifically, the FDIC must determine whether an institution is "essential" to the community in order to justify any transaction that is more costly than a deposit payoff and liquidation. This system has had two effects. First, the

-22-

form of this "cost test" is biased towards preserving franchise values were they exist; the result has been a higher likelihood of handling larger banks in a manner that protects all general creditors. Second, the FDIC is forced to explicitly justify any action that cannot be rationalized under the cost test. Thus, the term "too-large-to-fail" is inappropriate in the context of banking; a more appropriate term is "too-important-to-pay-off."

Moreover, the ability to deviate from decisions based solely on the cost test has had a long history and, more importantly, is likely to continue to be a fact of life--i.e., the "too-important-to-pay-off" doctrine in all probability is here to stay. That is to say, there will continue to be certain situations where an individual bank will be perceived to be too important to macroeconomic considerations or international stability to allow to be handled in a way that would inflict losses on bank creditors. This becomes increasingly true as other countries provide de jure or de facto 100 percent coverage to their banks, and as banking and finance become more international in scope. Thus, it would be counterproductive to design a system that does not accommodate this reality.

To the extent that handling bank failures involves broader macroeconomic considerations, some have questioned the appropriateness of vesting this responsibility with the deposit insurer. In Chapter 8, it is suggested that in the U.S. the insurance agency is appropriate for this purpose. First, the responsibility has been with the FDIC since 1934, and the system has worked reasonably well. Second, the way other countries allocate this responsibility--often to the central bank or ministry of finance--is not necessarily appropriate for the U.S. since relationships between government

-23-

and banking are often much different in those countries. Third, the nature of banking makes it important to act rapidly in a failure situation; this would not be consistent with exposing failure resolution to short-term political influence. Finally, failure resolution creates an interest in maintaining certain asset values; this interest normally will not be consistent with the conduct of appropriate monetary policy.

Resolving the FSLIC Problem

The difficulties experienced by the FSLIC and S&Ls during the 1980s have been the major impetus behind calls for insurance reform. Chapter 9 assesses the extent of the problem and outlines a number of options for dealing with the FSLIC crisis.

The FSLIC shortfall is probably between \$60 billion and \$115 billion, including \$10 billion to \$15 billion to provide for an ongoing S&L insurance fund. This is well in excess of the resources available to FSLIC. Because these losses continue to grow, insolvent S&Ls should be closed as quickly as possible and reforms instituted to minimize the chance of existing problems recurring.

The S&L industry should bear as much of the cost as possible. However, severe constraints exist on the ability of the S&L industry to finance the FSLIC shortfall--the tangible net worth of all solvent S&Ls is only \$40 billion, or four percent of their assets. There is a substantial risk that extensive use of S&L industry resources could drive presently healthy S&Ls

-24-

into insolvency or marginal solvency, and result in insurance-avoidance tactics, pressure to change insurers and increased risk-taking.

The banking industry also does not have the means to pay for the problem. Moreover, from an equity viewpoint, there is no reason why banks should pay for the S&Ls' problems. FDIC resources also should not be used due to the risk of leaving the agency with insufficient funds to fulfill its function.

The federal government must pick up most of the tab for the S&L problem. Concerns about the federal budget deficit could be mitigated by an off-budget financing arrangement, whereby the Treasury pays the interest and guarantees the principal of borrowings by a limited-life quasi-governmental agency. The recently created Farm Credit System Financial Assistance Corporation is an example. Off-budget financing has the advantage that it could avoid the politicalization of deposit insurance, which would seem inevitable if the costs were financed by appropriations.

Ensuring that current problems do not recur is at least as important as finding a short-term financial solution. The fundamental objective of a "regulatory solution" should be strong government regulation of the S&L industry instead of the de facto self-regulation which was a major cause of current problems. Under any scenario in which the FHLBB or FSLIC remain intact, FSLIC should be independent of FHLBB; the FHLBs should provide liquidity for housing, not supervise or examine the S&L industry; and the number of politically appointive positions in the FHLBB ought to be sharply

reduced. In addition, in any scenario, banks and thrifts should be regulated according to common standards.

In terms of balancing the objectives of rapid resolution of insolvencies and minimizing the chance that current problems will recur, a recapitalization of FSLIC with reforms to the FHLBB and the FSLIC, an administrative merger of FSLIC into FDIC, or the creation of a new deposit insurance agency combined with more comprehensive reform of the thrift industry are the most desirable options. Other options considered and deemed less desirable in terms of balancing these objectives include a recapitalization of FSLIC without reforms; an immediate full-scale merger of FSLIC and FDIC; a conversion of healthy S&Ls to FDIC insurance, with FSLIC or some other agency resolving the remaining cases; and a complete restructuring of the financial institutions regulatory system.

The three possible options that satisfy the requirements set forth in Chapter 9 can be called: (A) A stand-alone FSLIC; (B) An administrative merger of FSLIC into FDIC; and (C) Comprehensive reform of the thrift regulatory structure. The FDIC favors option A.

A stand-alone FSLIC envisions the creation of a separate FSLIC that is independent of the Federal Home Loan Bank Board (FHLBB). The FHLBB would continue to charter and supervise federal thrift institutions and would run both the Federal Home Loan Bank System and the Federal Home Loan Mortgage Corporation (Freddie Mac). The newly-separated FSLIC would directly supervise all state-chartered thrifts and be responsible for all liquidation activities related to FSLIC-insured institutions. The FSLIC would not be subject to the

-26-

appropriations process. The district Federal Home Loan Banks would no longer examine or supervise thrifts. Their role would be confined to providing liquidity for institutions meeting housing-related criteria. System membership would be available to any depository institution meeting these criteria.

The second option is an administrative merger of FSLIC into FDIC. There would be common management and an administrative Board over separate FDIC and FSLIC funds. The new FDIC would supervise state-chartered thrifts and state-chartered banks that were not members of the Federal Reserve System and would perform all liquidation activities for insured banks and thrifts.

The third option calls for comprehensive reform of the thrift regulatory structure. An administrative merger of FSLIC and FDIC would occur, creating a new federal deposit insurance corporation for banks and thrift institutions. The Office of the Comptroller of the Currency (OCC) would assume responsibility for chartering and supervising federal thrifts and the Federal Reserve Board would supervise thrift holding companies. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac, under the umbrella of the Department of Housing and Urban Development or the Federal Reserve Board.

Conclusions

In addition to the conclusions outlined thus far, Chapter 10 outlines some other broader conclusions and recommendations. One of these conclusions

-27-

is that the provision of deposit insurance should not interfere with the industry's adaptation to the technological changes affecting financial markets, regardless of whether these changes imply an expanded or more limited role for traditional banking activities. This is consistent with the recommendations of the FDIC's Mandate for Change study, which was published in 1987.

In Mandate for Change, it was argued that firewalls could be established between bank and nonbank affiliates to prevent the use of insured deposits for nonbanking activities, thus eliminating a potential advantage that banking organizations may have over nonbanking organizations. At the same time, the limitations imposed on the types of businesses that may own a bank place artificial restrictions on legitimate economies of scope and the flow of capital and other resources into and out of the banking industry. By eliminating these restrictions, it will be easier for the banking industry to adjust to the technological changes that are occurring, while ensuring that funding advantages are not given to nonbank entities.

The ability of the industry to adapt to technological and economic changes also would be enhanced by allowing for a more orderly entry into and exit from the industry. Restrictions on intrastate branching and interstate banking impede the orderly entry into and exit from the industry, and increase the FDIC's costs of resolving failures. In addition, these restrictions limit loan diversification, thereby increasing risks to the system. The elimination of these geographic restrictions would allow the industry to be more responsive to changing financial conditions and regional difficulties.

Throughout the chapters of this Study, questions concerning the trade-off between financial stability and market discipline are raised. Reform proposals that call for greater market discipline have the potential to reduce the risk-taking incentives that deposit insurance provides, but they also have the potential to create costs by increasing the chances of bank runs.

Underlying reform proposals that call for greater amounts of market discipline, by strictly enforcing de jure coverage or rolling back the insurance coverage, is the view that markets (deposit markets) are relatively efficient at evaluating bank risk and that costs of the increased chances of bank runs are relatively low. Thus, in this view, the benefits of increased depositor discipline outweigh the costs.

In this Study the view is that existing forms of market discipline in well-capitalized banks, when combined with prudent supervision, are sufficient to control any incentives for excessive risk-taking by banks caused by the existence of deposit insurance. At the same time, it is the FDIC's view that bank runs or the threat of bank runs can be costly, and that any moves toward enhancing market discipline must seriously weigh these potential costs. Consequently, the Study stresses the need to enhance existing forms of market discipline; to strengthen supervision so that overly risky behavior is detected and controlled in a timely manner; to maintain strict capital standards and ensure that insolvent institutions are promptly closed; and to provide insuring agencies with the proper incentives so as to facilitate the long-term viability of the federal deposit insurance system.

APPENDIX A to Chapter 9

PROGRAM FOR DEPOSIT INSURANCE REFORM AND AGENCY RESTRUCTURINGSUMMARY

The following summary and outline set forth a program for deposit insurance reform. Part I contains three alternative plans for agency restructuring as part of the resolution of the FSLIC situation. Part II proposes options for resolving the FSLIC/thrift crisis and Part III recommends deposit insurance reforms generally.

The three plans for agency structural reforms are:

● Plan A -- Creation of a separate FSLIC that is independent of the FHLBB. The FHLBB would maintain its current Board composition and continue to charter and supervise federal thrifts and run both the Home Loan Bank System and Freddy Mac. The newly-separated FSLIC would, generally, mirror the FDIC. It would supervise all state-chartered thrifts and be responsible for all thrift liquidation activities -- including the resolution of insolvent thrift cases and FADA. The composition of the FSLIC Board, its degree of administrative independence and its authorities and responsibilities would track those of the FDIC. Thus, the Chairman of the FHLBB would be on the FSLIC Board, in the same manner as the Comptroller is on the FDIC Board. Given a choice, the FDIC would prefer Plan A.

● Plan B -- Administrative merger of the FSLIC into the FDIC. The FHLBB would maintain its current Board composition and perform the same functions as under Plan A. However, the FSLIC would be administratively merged into the FDIC. Two new members would be added to the FDIC Board, including the FHLBB Chairman and an additional outside director. In addition to administering the two separate funds, the FDIC would supervise state-chartered thrifts and nonmember banks and perform all liquidation activities for all insured thrifts and banks. Its responsibilities would include disposition of insolvent thrift cases and FADA.

● Plan C -- Comprehensive reform of the deposit insurance system and the supervisory structure. This Plan involves a new Insurance Corporation headed by a politically independent 5-person Board that administers both the bank and thrift insurance funds. Plan C also revises the supervisory structure for all thrift institutions. The OCC would assume responsibility for chartering and supervising federal thrifts and the FRB would be responsible for thrift holding companies. The FHLBS would continue to oversee the FHL Bank System and Freddy Mac under the umbrella of HUD or the FRB.

Following the three plans for agency restructuring, the outline contains recommendations for the FSLIC/thrift crisis (Part II) and deposit insurance reform recommendations (Part III).

PROGRAM FOR DEPOSIT INSURANCE REFORM AND AGENCY RESTRUCTURINGOUTLINE

The following describes a program for deposit insurance reform and resolution of the FSLIC crisis, as well as three alternative plans for agency restructuring. The document consists of three parts:

I. Three alternative plans for agency restructuring

PLAN A - Creation of a separate FSLIC that is independent of the FHLBB (The FDIC favors this Plan)

PLAN B - Administrative merger of FSLIC into FDIC

PLAN C - Structural reform of deposit insurance, chartering and supervisory agencies

II. Recommendations for the FSLIC/thrift crisis

III. Deposit insurance reforms generally

I. Three Alternative Plans for Agency Restructuring

The description of each plan will include: objectives; a diagram of agency structure and functions; and an outline describing the plan.

PLAN A

AN INDEPENDENT FSLIC SEPARATE FROM THE FHLBB

Objectives of Plan A

- Separate the FSLIC from the FHLBB
- Avoid "micro-management" by statute of the FSLIC and its mandate -- i.e., allow the FSLIC flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it and the FDIC to make long-range recommendations to the Congress
- The FSLIC should be "off budget" and independent of the appropriations process (FDIC also should be moved "off budget")
- Work toward regulatory and supervisory standards for thrifts that are comparable to those for banks.

DIAGRAM OF PLAN A -- AN INDEPENDENT FSLIC



Functions

- Perform all liquidation activities -- including resolution of all insolvent thrift cases and asset liquidations (would have responsibility for FADA)
- Supervise all state-chartered thrifts
- Make recommendations (along with the FDIC) to Congress for further reforms

Functions

- FHLBB charters and supervises federal thrifts and oversees thrift holding companies. (FHL Banks no longer supervise thrifts)
- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- Oversee Freddie Mac (which ultimately could be privatized)

- 3 -

Outline of Plan A

- A. The FSLIC would be separated from the FHLBB and, generally, the FSLIC would be a mirror image of the FDIC. This is the Plan that is preferred by the FDIC.
1. Board composition - The FSLIC would have a three-person Board. The Chairman of the FHLBB would be on the Board in the same manner as the Comptroller is on the FDIC Board. However, the FHLBB Chairman could not chair the FSLIC.
 2. The FSLIC and its budget would not be subject to the appropriations process and would have the administrative independence of a "mixed ownership corporation" (patterned after FDIC).
 3. Prospectively, the FSLIC would be the insurer for only those institutions that operate as thrifts -- i.e., those that meet the qualified thrift lender (QTL) or some similar "housing-related" standard.
 4. Authorities and responsibilities of the FSLIC.
 - a. The FSLIC -- like the current FDIC -- will be charged with protecting insured depositors, the integrity of the insurance fund and the safety and soundness of the FSLIC-insured system.
 - b. The FSLIC is to be responsible for all thrift liquidation activities -- including resolution of insolvent thrift cases and FADA. Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.
 - c. The FSLIC is to be the primary federal supervisor for all state-chartered thrifts.
 - d. The FSLIC will have the same authorities and powers relative to state and federally chartered thrifts that the FDIC now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).
 - e. The FSLIC is required to adopt standards for thrifts that are comparable to those for banks -- i.e., capital, accounting, liquidity, lending limits and other safety and soundness standards.
 - f. The FSLIC (and the FDIC) will be charged by Congress to make recommendations within one year for further reforms.
 4. Some of the existing experienced Federal Home Loan Bank examiners would be allocated to the FSLIC.

B. Federal Home Loan Bank Board

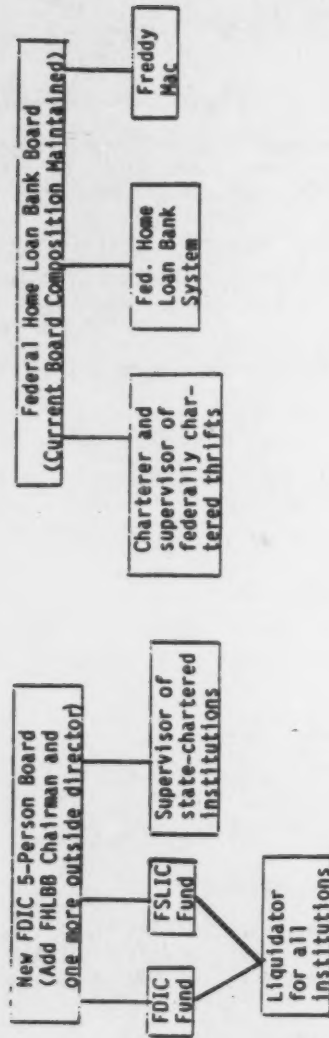
1. Federally chartered thrifts would continue to come under the jurisdiction of the FHLBB. The FHLBB would:
 - a. Charter federal thrifts.
 - b. Implement and administer the Home Owners' Loan Act.
 - c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks -- which is desirable since they are not independent of the industry).
 - d. Administer the S&L Holding Company Act.
2. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac. However, changes would be necessary to the FHLB System.
 - a. The System would no longer supervise or examine thrifts.
 - b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.
 - c. Over the long term, it may be advisable to completely privatize Freddy Mac.

PLAN B

ADMINISTRATIVE MERGER OF FSLIC INTO FDICObjectives of Plan B

- Separate the FSLIC from the FHLBB
- Provide for an administrative merger of the FSLIC into the FDIC
- The "new FDIC" should be moved "off budget"
- Avoid "micro-management" by statute of the new FDIC and its mandate -- i.e., allow the FDIC flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it to make long-range recommendations to the Congress
- Work toward comparable insurance premiums and common standards of regulation and supervision for banks and thrifts

DIAGRAM OF PLAN B -- ADMINISTRATIVE MERGER OF FSLIC INTO FDIC



Functions

- Administer two separate insurance funds -- FDIC and FSLIC
- Perform all liquidation activities -- including resolution of all insolvent thrift cases and asset liquidations (would have responsibility for FADA)
- Supervise state-chartered thrifts, as well as state nonmember banks
- Make recommendations to Congress for further reforms

Functions

- FHLBB charters and supervises federal thrifts and oversees thrift holding companies (FHL Banks no longer supervise thrifts)
- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- Oversee Freddie Mac (which ultimately could be privatized)

Outline of Plan B

- A. The FSLIC would be administratively merged into the existing FDIC. The FDIC would have responsibility for administering the two funds, taking care of the insolvent thrift institutions (see II) and making recommendations to the Congress for further reforms.
1. FDIC Board Composition
 - a. The FDIC Board would be expanded to include the FHLBB chairman and an additional outside director.
 - b. No more than two of the three outside directors could be of the same political party.
 2. Authorities and responsibilities of the new FDIC.
 - a. The FDIC is to administer two financially separate and distinct funds. Two separate premium income streams are to continue to be allocated to the separate funds. Expenses are to be charged against, and reserves allocated to, the appropriate fund.
 - b. The FDIC is to be responsible for all liquidation activities -- including resolution of insolvent thrift cases and FADA (which probably would be phased out). Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.
 - c. The FDIC is to be the primary federal supervisor for state-chartered thrifts, as well as nonmember banks.
 - d. The FDIC has complete authority to determine the administrative structure of the agency.
 - e. The FDIC has the same authorities and powers relative to state and federally chartered thrifts that it now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).
 - f. The FDIC is charged by Congress to make recommendations within one year for further reforms over and above those made at the time of enactment of the legislation that administratively merges the FSLIC into the FDIC. (See III)
 4. Some of the existing experienced Federal Home Loan Bank examiners would be allocated to the new FDIC.
- B. Federal Home Loan Bank Board
1. Federally chartered thrifts would continue to come under the jurisdiction of the FHLBB. The FHLBB would:

- 7 -

- a. Charter federal thrifts.
 - b. Implement and administer the Home Owners' Loan Act.
 - c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks).
 - d. Administer the S&L Holding Company Act.
2. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac. However, changes would be necessary to the FHLB System.
- a. The System would no longer have overall responsibility for supervising thrifts.
 - b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.
 - c. Over the long term, it may be advisable to completely privatize Freddy Mac.

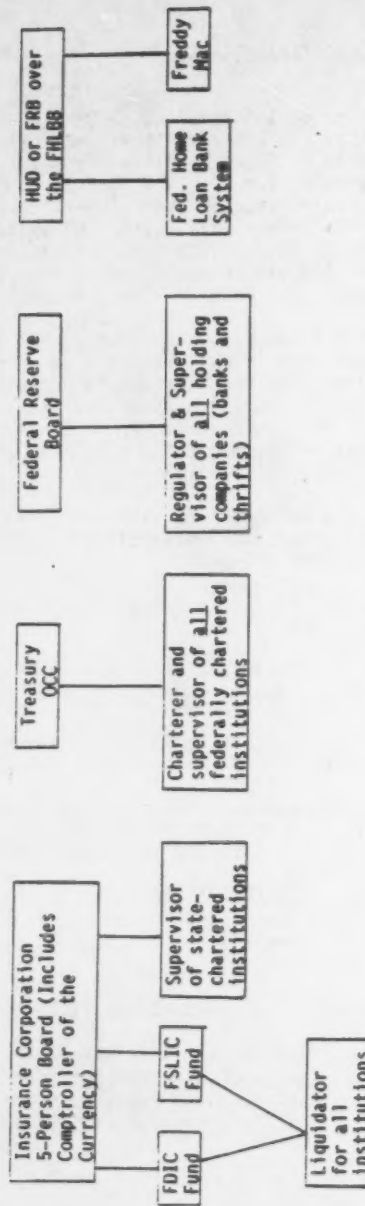
PLAN C

REFORM OF THE DEPOSIT INSURANCE SYSTEM
AND THE SUPERVISORY STRUCTURE

Objectives of Plan C

- Separate the FSLIC from the FHLBB
- Provide for common management of the FSLIC and the FDIC by a politically independent Corporation that is responsible for all FSLIC and FDIC-insured institutions -- including the currently insolvent thrifts
- The Insurance Corporation should be "off budget" and independent of the appropriations process
- Avoid "micro-management" by statute of the new Corporation and its mandate -- i.e., allow the Corporation flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it to make long-range recommendations to the Congress
- Work toward comparable insurance premiums and common standards of regulation and supervision for banks and thrifts
- Create a structure for chartering and supervising federal thrifts and thrift holding companies that tracks that of banks.

DIAGRAM OF PLAN C --- REFORM OF DEPOSIT INSURANCE AND SUPERVISORY SYSTEMS



- Administer two separate insurance funds - FDIC and FSLIC
- Perform all liquidation activities -- including resolution of all insolvent thrift cases and asset liquidations (would have responsibility for FADA)
- Supervise state-chartered thrifts and state nonmember banks
- Make recommendations to Congress for further reforms
- Charter both nat'l banks & fed. thrifts
- Supervise both nat'l banks & fed. thrifts
- Administer both the National Bank Act and Home Owners' Loan Act
- Comptroller to be on the Board of the Insurance Corporation
- Regulate & supervise both bank & thrift holding companies
- Continue to supervise state member banks
- Continue monetary policy function
- Continue to administer payment system
- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- FHL Banks no longer supervise thrifts
- Oversee Freddy Mac (which ultimately could be privatized)

Outline of Plan C

The new structure entails breaking up the existing FHLBB structure and moving most of its functions elsewhere. This accomplishes the following objectives: (1) separates the charterer of federal thrifts from the insurer; (2) allows for an administrative merger of the FDIC and FSLIC; (3) consolidates the chartering and supervision of federal thrifts with that of national banks; (4) consolidates the federal regulation and supervision of most state-chartered institutions in one agency; (5) consolidates the regulation and supervision of all holding companies in one agency; and (6) maintains the important functions of the Federal Home Loan Bank System.

- A. Insurance Structural Reform - An administrative merger of the FDIC and the FSLIC. This envisions a government-controlled Corporation (hereinafter the "Corporation") that administers two separate and distinct insurance funds. The Corporation is to have responsibility for administering the two funds, taking care of the insolvent thrift institutions (see II) and making recommendations to the Congress for further reforms.
1. Corporation composition - Managed by a board of directors (the "Board") which is structured to promote political independence (similar to the structure of the FRB).
 - a. Five-person Board with long, staggered fixed terms (recommend 8-year terms).
 - b. President appoints Chairman from the Board for a shorter term (possibly a 4-year term).
 - c. The Comptroller of the Currency would be on the Board in the same manner as the Comptroller is now on the FDIC Board.
 - d. No specified political composition (although initial Board should have no more than three persons from the same political party to avoid "stacking" the first Board).
 2. The Corporation and its budget would NOT be subject to the appropriations process and would have the administrative independence of a "mixed ownership corporation" (patterned after FDIC).
 3. Authorities and responsibilities of the Corporation.
 - a. The Corporation is to administer two financially separate and distinct funds. Two separate premium income streams are to continue to be allocated to the separate funds. Expenses are to be charged against, and reserves allocated to, the appropriate fund.

- b. The Corporation is to be responsible for all liquidation activities -- including resolution of insolvent thrift cases and FADA. Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.
 - c. The Corporation is to be the primary federal supervisor for state-chartered thrifts and nonmember banks.
 - d. The Corporation has complete authority to determine the administrative structure of the agency.
 - e. The Corporation has the same authorities and powers relative to state and federally chartered banks and thrifts that the FDIC now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).
 - f. The Corporation is charged by Congress to make recommendations within one year for further reforms over and above those made at the time of Corporation formation. (See III)
- 4. The existing experienced Federal Home Loan Bank examiners would be transferred to the new Corporation, the OCC and the FRB.
- B. Federally Chartered Thrifts
 - 1. Federally chartered thrifts would come under the jurisdiction of the OCC.
 - 2. The OCC would perform the same functions for federal thrifts that it now performs for national banks. It would:
 - a. Charter federal thrifts.
 - b. Implement and administer the Home Owners' Loan Act.
 - c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks -- which is desirable since they are not independent of the industry).
- C. Thrift Holding Companies
 - 1. Regulation and supervision of thrift holding companies under the S&L Holding Company Act would be given to the FRB.
- D. Federal Home Loan Bank System/Freddy Mac - The FHLBB would continue to oversee the FHL Bank System and Freddy Mac under the umbrella of HUD or the FRB.

- 11 -

1. The FHLB System would maintain much of its current functions.
 - a. It would have a mandate to promote housing.
 - b. It would provide funding to the industry.
2. Changes would be necessary to the FHLB System.
 - a. The System would no longer supervise or examine thrifts.
 - b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.
 - c. Over the long term, it may be advisable to completely privatize Freddy Mac.

II. Recommendations for the Thrift/FSLIC Crisis

- A. Resolution of the crisis would be the responsibility of the insurance agency (i.e. FSLIC under Plan A, FDIC under Plan B and the new Corporation under Plan C), following a program mandated by Congress.
- B. The mandate to the insurer would be as follows:
 1. To resolve the worst 100 first (estimates are that it will take about \$30 billion and at least six months to resolve the 100 or so "worst" institutions).
 2. To resolve the rest of the insolvent thrift cases subject to Treasury and Congressional oversight over an extended period.
 - a. Funding could be subject to a requirement that periodic draws be approved by Treasury.
 - b. Periodic progress reports to Congress also would be required.
- C. Broaden potential acquirors for troubled thrifts by mandating that the FRB eliminate the restrictions imposed on bank holding company acquisitions of such thrifts.
- D. Funding
 1. Funding would be a combination of government borrowing and thrift industry resources (to the extent that the industry can shoulder the burden), including tapping some of the resources of the Federal Home Loan Bank System.
 2. The insurance agency(ies) should be on a "separate budget" that is subject to Congressional oversight.

- 12 -

3. The insurer should be permitted to borrow, unsecured, from the FRB (or Treasury) at a rate no higher than the Fed discount rate.
4. The special 1/8 of 1% thrift premium assessment and the moratorium on conversions to the FDIC should be addressed by Congress.
 - a. Under Plan A, the special premium would extend for at least one year and the moratorium would terminate when assessments return to normal.
 - b. Under Plans B and C, the FDIC or the new Corporation, respectively, would be responsible for making determinations regarding the special assessment and the conversion of institutions from one fund to the other.

III. Deposit Insurance Reforms Generally

These reforms would be contained in the legislation creating the new insurance structure. They would be permanent reforms to the deposit insurance system that would apply to the insurance agency(ies) (i.e. Both FSLIC and FDIC under Plan A, the new FDIC under Plan B or the new Corporation under Plan C).

- A. Insurance premiums that reflect the experience of the insurer(s) would be authorized. The insurer would be permitted to increase or decrease premiums as called for by insurance expenditures.
 1. The basic formula would be set out in the law.
 2. If there is a common administrative Board, at the outset the formula would be applied to each fund separately based on the experience of each separate fund. Over the long term, the objective should be to have the formula for establishing premiums the same for both industries.
- B. With respect to federally chartered institutions and state member banks, the chartering authority would be required to certify to the insurer that each institution to which it grants a charter is eligible for insurance based on standards established by the insurer.
- C. Insurers would be authorized to terminate insurance (i.e., take Section 8(a) action) much more rapidly -- in six months or less -- than under current law.
- D. The enhanced enforcement authorities adopted by both House and Senate Banking Committees in the 100th Congress would be enacted.
- E. The insurer would be authorized to establish minimum capital standards for all insured institutions in cooperation with the chartering authorities.

- 13 -

- F. Insured institutions in holding companies would be required to guarantee their insurer against any insurance losses caused by other insured institutions in the holding company.
- G. The insurer(s) would be mandated to make standards of regulation and supervision for banks and thrifts uniform over time.
- H. The insurance agency(ies) would be moved "off budget" and removed from the budget process.
- I. The insurance agency(ies) and other federal regulatory authorities would be required to make further reform recommendations to the Congress in prescribed areas, including the following:
 - 1. Merger of the two separate insurance funds (or, under Plan A, the two separate agencies).
 - 2. Additional powers (enforcement and otherwise) required by the insurer to protect the insurance funds.
 - 3. Whether there is a need for restructuring of the credit union agency structure -- such as separating the NCUSIF from the NCUA.
 - 4. Comprehensive long-term reforms to the insured financial institutions industry that are necessary to allow those institutions to attract capital and be competitive both at home and abroad. Industry reforms to be considered are:
 - a. Permitting an array of activities outside the boundaries of the insured institution itself that are patterned after those permitted unitary thrift holding companies (i.e., unlimited activities).
 - b. Strict firewalls around insured institutions and strict supervision and enforcement of the firewalls.
 - c. Permitting activities that are required to be outside the "insurance wall" to be conducted either in holding companies or subsidiaries.
 - d. Requiring investment in any activities that are impermissible to the insured institution itself to be out of excess capital.
 - e. Providing the insurer with clear authority to require any institution to move an activity that the insurer deems inappropriate for insurance coverage outside the insured entity -- into its parent, a affiliate or a subsidiary.

Mr. GIBBONS [presiding]. Thank you, Mr. Seidman.
Mr. Wall.

STATEMENT OF HON. M. DANNY WALL, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD, ACCOMPANIED BY LARRY WHITE AND ROGER MARTIN, BOARD MEMBERS

Mr. WALL. Thank you, Mr. Chairman.

It is a pleasure to be here, today, as well to present testimony on behalf of the Federal Home Loan Bank Board. I am accompanied by my colleagues Mr. White and Mr. Martin, and will be calling on them for their comments as the day proceeds.

I will be responding to the three basic questions posed in your letter of invitation. Attached to our testimony is the response to the chairman's specific questions.

I would also like to point out a correction or identify an omission that resulted in a computer print out of the testimony. In the next to the last paragraph on the bottom of the first page, part of the sentence is dropped. For December only, in order to have liquidated the institutions would have required \$46 billion in cash, and for the year 1988, \$79 billion in cash would have been required.

First, by way of background, I became the Chairman of the Federal Home Loan Bank Board on the 1st of July in 1987. I was greeted by an excess of 500 insolvent institutions with growing operating losses, no methodology for estimating the size of the problem, and a recapitalization bill under debate in the Congress where it had been under debate for over 18 months, and which continued to be for another 6 weeks.

The debate, as some of you will recall, concerned whether \$5 billion, \$7½ billion or \$15 billion was enough to resolve all the known troubled institutions. The compromise ended up being \$10.8 billion and we were told to go on our way and do with what we could. That legislation was signed into law on the 10th of August of 1987.

Case resolution resumed immediately after the legislation was passed. For the remaining months of 1987, we were able to resolve 21 institutions to a large extent, although not exclusively, the traditional one-on-one merger approach. Resolving a total of 47 institutions in 1987.

In 1988, the numbers were, indeed, significantly greater. We resolved 205 institutions: 26 by virtue of an insurance payout or transfer of insured account, so-called liquidations; and 179 by assisted mergers. We stabilized an additional 18 institutions by consolidating them into 7 consolidations.

The mergers and acquisitions, as well as the liquidations cost \$31 billion. The mergers and acquisitions are estimated as costing \$28.3 billion. Stabilization as we call them, \$7 billion.

During that same timeframe, the last half of 1987, we put into effect eight sets of regulations that the agency was mandated to promulgate before the end of the year.

In August of 1987, a month after assuming the office, I made my first public speech before the Press Club here in Washington. At that time, I talked about two deadlines that were ahead of us, one being the fiscal year, 1 year and 1 month later, and the other being the calendar year, 1 year and 4 months later. We projected in

August of 1987 what we expected the end of 1988 activities to involve.

We proceeded to deal with the case resolutions as I had indicated in 1987, in the one-on-one acquisition approach. In December 1987, however, we dealt with a four institution mergers in the State of Louisiana known as the Pelican Deal.

We identified 2 months later, rather a month and a week later, when we announced the Southwest plan, that the Pelican Deal was an approach to be used when consolidating multiple institutions into one. This approach reduces the redundancies in order to begin to wring out the "over-banked" status prevalent in the Southwest. We announced then that people should look to the Pelican case of a month plus earlier, as an example of what the Southwest plan was going to be.

The attention that is focussed on December of 1988 is really an unfortunate focus because the action began by coincidence 1 year earlier, December of 1987, in almost identical form.

As aforementioned in 1988, we liquidated 26 institutions. In order to do liquidations, you have to have the cash up front, large amounts of cash up front. To have liquidated the institutions that were resolved in December alone would have required \$46 billion in up front cash. And, of course, in order to have liquidated the 176 institutions that were not liquidated last year, would have required \$79 billion of up front cash, and the ability to wait for the return on the sale of assets.

An additional point that has not gotten enough attention is the amount of new capital expected to be brought into this business.

There is a capital regulation in place that requires the capital ratio to be increased over time by those institutions that are in business and want to remain in business. We have pending, regulations for risk-base capital formulation which would require greater amounts of capital to be provided for ownership of institutions that want to continue in business. and the President's proposal talks about requiring perhaps even still more capital, or a different kind of a capital standard.

In FSLIC's assisted acquisitions resulted in contributed capital of over \$3 billion. Three billion dollars was brought by purchasers, investors, and those dealmakers with whom we were able to conclude transactions.

The current estimate of \$75 to \$80 billion on a discounted present value basis in in agreement with the Treasury Department, the FDIC's and the GAO estimates.

The President's proposal, we believe, is a very comprehensive and bold package and one that warrants very serious consideration and approval by the Congress. We have already begun, by contract with the FDIC, to provide for the FDIC to take over the management of insolvent insitutions under conservatorship authority. FDIC is taking over the management of what will be perhaps 220 institutions that are currently insolvent.

Other points of the President's proposal would provide for a total of \$900 billion of resources to be applied to solving the problem. A restructured insurance agency; the administrative merger of the FSLIC and the FDIC with, as I described it, two separate check-books so as to keep the premium flows distinctly separate, and the

assistance distinctly separate as well. And a restructured regulatory agency. These issues may be discussed further if you wish to pursue them.

One of the words that is so often used by the headline writers and by others is "bailout". I have not heard a word more inappropriately used with respect to the savings and loan industry. The industry is not being bailed out. The stockholders are gone when we come in and takeover an institution. The management that caused the problems, or was there when the problems occurred is gone when we takeover the institution.

We make good on the pledge to provide security for insured deposits. That is not a "bailout" by any standard.

Why did these problems occur? I heard the discussion of the previous witness and he only touched upon a limited number of the elements that I believe came into play in an uncanny combination of events and circumstances that have caused and/or permitted the problem to occur and have caused or permitted it to become the scale that it has.

Perhaps you can begin as the previous speaker did in the late 1970's with the interest rate spread problems. The industry had to pay more for deposits than they could earn on those long standing fixed payments mortgages.

In 1980, interest rate deregulation put into place liability deregulation with insufficient assets. On the one hand institutions had to pay more interest on the deposits than they had, and on the other hand, they were not given adequate opportunities to earn greater income with which to pay those higher yields.

Liberal State charters: Three States: Oklahoma, Louisiana, and Texas had very liberal State charters.

Regulators: There were not enough regulators at the State and Federal levels. Clearly, there was culpability in the early 1980's as far as the regulatory agencies were concerned. During that same timeframe, however, some States indeed did further regulate their charters. States like California, Florida, Utah, Ohio, and so forth, tried to emulate the opportunities that existed in some of more liberal State charters that I mentioned earlier.

A booming oil patch economy: The Continental Illinois National Bank, some of the finest or what were perceived to be some of the finest commercial loan underwriters in the world were betting on high oil and gas prices, and they lost their bank on the basis of a "bad" bet. The booming oil patch economy caused greater attraction to that part of the country. The real estate in that part of the country was booming, and I do not mean just Texas—but also Oklahoma, Louisiana, Arkansas, and New Mexico. Those States had bet on higher energy prices, and then, of course, there was an energy price crash.

The 1986 Federal tax changes: The 1986 provisions provided inadequate transitional provisions on the back of an already severely damaged real estate market. The Southwest, had gotten overheated and was already feeling the effects of the energy price crash.

Finally, to throw the net even still further, the FSLIC recapitalization. I alluded to earlier, took 19 months, which was far too long. I do not think that I need to go through the extent to which this issue is much more a congressional and an administration con-

sideration than an agency recommendations as to how the budget and fiscal aspects should be handled.

I would like to make two or three specific points, because they are oftentimes misunderstood or not recognized. First, all FSLIC financial activities are on budget, and have been ever since the late 1960's, when both the FDIC and the FSLIC were brought on budget for budgeting purposes. Back in those days we were considered a net benefit to the budget.

Second, the financial corporation or FICO, as it is called, the mechanism that recapitalizes the Federal Savings and Loan Insurance Corporation, is off budget, but all of the borrowings of that entity flow through the budget as they are utilized as income coming into the FSLIC.

The full amount of any FSLIC note, the assistance that was used in large part last year, is booked in its entirety in the year in which it is issued.

Yield maintenance indemnification and other FSLIC guarantees are not booked until the cost can be realized or can be more clearly identified.

As I indicated, in an acquisition or merger, you have the benefit of lower up-front costs. You have, of course, to pay overtime and have the benefit of recovery. The benefit of recovery in the asset values, as well as the benefit of recovery in the institution. It was given attention, but far too little attention in the previous testimony, that we take warrant positions in every one of these institutions so that we have an up-side position in the institution's success. That success will be a significant part of how the overall and long-term costs of resolving the institutions can be met. As these institutions recover, we have a share in their increased value whether it be a greater tax benefit than had been estimated at the outset, or recovery of the value of the assets to that acquirer. We have a benefit in the ownership of those assets plus, to the extent the institution gets a share for having successfully managed those assets, and they do better as a result, we have a share of that income as well. So, we have in a sense a fail-safe share in the success of these institutions by virtue of our warrant positions. Both the FDIC and the FSLIC have increasingly issued more warrants, especially in providing longer term contractual relationship with the acquirers.

Moreover, we are able to benefit from shrinkage within the industry since we are part of a contractual arrangement that lasts for 10-year periods.

Liquidation: As previously indicated there is clearly, a huge up-front cost and obligation in having to have cash to resolve failed institutions. As has been said, we did not have the resources other than the ability to issue notes, provide guarantees and a limited amount of cash, with which to make the deals that we made last year.

Let me say on the last category, the area of tax provision, we very much appreciate the consideration that this committee and your counterpart committee on the other side of the Hill gave to the question of technical amendments concerning the extension of the tax free treatment of FSLIC assistance.

These tax provisions, at least with respect to the FSLIC, go back to about 1981. The purpose of the legislation was to place the acquisition of troubled thrifts which often involved mutual rather than stock associations, on the par with reorganizations that could qualify for tax-free reorganization treatment. The provision as to the tax-exempt nature of the FSLIC assistance payments were needed to clarify the treatment of these payments.

So, going back to 1981, there have been tax benefits quite intentionally included in legislation and increasingly more misunderstood as time has gone on.

Let me bring my comments to a close by making the observation that tax policy should be balanced against the level of funding Congress includes as part of the administration's package. The chairman made reference to that in his opening comments, and I think it is clearly a part of the consideration that needs to be made.

If I might, Mr. Acting Chairman, call on my colleague, Mr. White, who is clearly our in-house tax expert, to give a brief review of some of the details of some of the recent tax transactions.

[The statement of Mr. Walls and his response to Chairman Rostenkowski's letter follow:]

STATEMENT OF M. DANNY WALL, CHAIRMAN
FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and members of the Committee, I am pleased to appear before you today to discuss the budget implications and relevant tax rules regarding troubled savings and loan institutions.

You have asked that I and other invited guests comment on three areas of concern: the magnitude of the financial difficulties of the savings and loan industry and the costs, structure, and appropriateness of any potential Federal assistance; the budget and policy implication of the industry's financial difficulties; and the relevant tax provisions.

You have also asked that I respond to several specific questions concerning, among other things, the cost and method of case resolution through either acquisition or liquidation, and the incentives used to better ensure that managers will maximize returns on covered assets. The answers to those questions are attached to this statement.

I. BACKGROUND: Summary of Recent Bank Board Activities.

First, by way of background, I would like to recap briefly the activities of the Federal Home Loan Bank Board (the "Bank Board") and the Federal Savings and Loan Insurance Corporation ("FSLIC") over the past eighteen months.

When I assumed the chairmanship of the Bank Board in July, 1987, there were over 500 institutions insolvent according to Generally Accepted Accounting Principles ("GAAP") with constantly growing operating losses, no methodology for estimating the size of the insolvency problem, and a recapitalization bill that was still in the midst of a heated Congressional debate on whether the amount should be \$5 billion or \$7.5 billion. A recapitalization bill with \$10.8 billion was not finally enacted until some 6 weeks after my arrival at the Bank Board. (The Competitive Equality Banking Act of 1987 ("CEBA")), Pub. L. 100-86, August 10, 1987).

With the new financing authority in CEBA, we were able to resume case resolutions, completing 21 resolutions from August 1987 through year-end 1987. In that same period of time, we promulgated the eight new regulations mandated by CEBA to strengthen our regulatory posture.

Since January 1988 we have engaged in a very aggressive year-long effort to resolve even more cases. In calendar year 1988, we resolved 205 cases at a total cost of \$31.2 billion. We stabilized another 18 cases at a cost of \$7 billion. Of these 205 resolutions, we completed 179 mergers and acquisitions at a total cost of \$28.4 billion, and completed 26 liquidations (insurance pay-outs or transfers of accounts) at a cost of \$2.8 billion. Had we liquidated instead of merged the 179 institutions, the present value cost would have been \$37.2 billion and the up-front cash requirements would have been significantly greater. Just for the December transactions, the cash required for the liquidations would have been \$79 billion. We pursued these resolutions aggressively because of the critical importance of stopping the rising FSLIC liability caused by insolvent institutions continuing to operate. We believe this achieved some important results.

Focusing on the largest and most troubled institutions, we were able to resolve 60 of the worst 100 institutions insolvent under Regulatory Accounting Principles. Had we not resolved the 205 cases, their annualized operating losses would have been at least \$4.2 billion. Deals completed in 1988 resulted in contributed capital in excess of \$3 billion. Finally, we were able to reduce the overall cost of funds fueled by the existence of insolvent institutions in the marketplace.

To facilitate these resolutions we used a combination of financing vehicles. First, we used Financing Corporation ("FICO") bonds authorized under CEBA which is off-budget financing although the proceeds of such bond sales are on-budget receipts to the FSLIC. Total outstanding FICO bonds are now \$5.85 billion. Second, we used FSLIC notes which are considered on-budget items when issued. The total amount of FSLIC notes outstanding as of December 31, 1988, was \$20.5 billion, an increase of \$15.2 billion from December 31, 1987. Third, we used other forms of FSLIC guarantees that are scored as budget items when actually paid out. In 1988, we issued \$18 billion in such guarantees -- total outstanding FSLIC guarantees are now \$18.7 billion. In summary, total FSLIC assistance (notes plus guarantees issued) in 1988 amounted to \$32.5 billion. Total outstanding FSLIC assistance is now \$39 billion.

I would also like to present you with a review of the many changes the Bank Board has made in its regulation of the industry since 1985. To that end, we have attached as Exhibit A a detailed description of the various regulatory and supervisory initiatives the Bank Board has pursued over the past few years. The Bank Board believes these changes go a long way toward establishing a regulatory structure that will prevent a recurrence of the existing situation.

II. The Magnitude of the Financial Difficulties of the S&L Industry.

A. Costs.

The cost of resolving cases that are known to us at this time is estimated at \$75 to \$80 billion on a discounted present value basis. This estimate includes only future assistance and unpaid commitments (including outstanding notes) already entered into that can be reasonably estimated at this time, and is not a projection of the cost of resolving all future problems in the savings and loan industry.

B. Structure - the President's Proposal.

In early February 1989, the Administration announced its plan to resolve the crisis in the thrift industry and to place federal deposit insurance on a sound basis. As I understand it, the plan would create and fund a new corporation to pay the cost of closing all insolvent thrift institutions, reorganize the regulatory structure of the thrift industry and reform the federal deposit insurance system. Key aspects of this plan require congressional authorization.

The Administration's plan calls for the creation of a private corporation, the Resolution Trust Corporation, to resolve currently insolvent institutions. This corporation will contract with the Federal Deposit Insurance Corporation (the "FDIC") to manage insolvent institutions and will be funded with the proceeds of a \$50 billion 30-year bond issuance of the Resolution Funding Corporation. The principal on these bonds will be repaid entirely with thrift industry funds, including the retained earnings of the Federal Home Loan Banks ("FHLBanks"), the proceeds from the disposed assets of the insolvent institutions, and deposit insurance premiums. Interest payments on these bonds will be covered first by thrift industry funds with Treasury funds covering any shortfall.

The current board of the Bank Board would be replaced by a Chairman of the Federal Home Loan Bank System who, like the Comptroller of the Currency, would report to the Secretary of the Treasury. The entire thrift regulatory structure would report to the Chairman of the Federal Home Loan Bank System. In addition, a joint supervisory program would be initiated with personnel from all of the federal agencies that regulate financial institutions to oversee the activities of troubled thrift institutions. New enforcement authorities would be granted and the FDIC would be permitted to use stricter

-3-

standards for providing insurance and empowered to limit the risk-taking of state-chartered institutions that it insures. Thrift institutions would be required to meet standards as strict as the capital standards imposed on FDIC-insured banks by June 1, 1991, and, thrift institutions and their regulators would be required to use new uniform accounting, supervisory, and disclosure standards.

The FSLIC would be separated from the Bank Board and merged administratively with the FDIC, thereby creating an independent insurance agency to protect depositors and maintain the security of the deposit insurance funds. The two deposit insurance funds would be maintained, however, and separate streams of deposit insurance premiums would be paid by thrifts and banks to their respective funds. At the same time, premiums paid by both banks and thrifts would be raised to cover current losses as well as to increase reserves to protect against future losses. Premiums paid by banks would not be used to resolve insolvent thrift institutions or to shore up the FSLIC, but only to bolster the reserves of their own fund.

The \$90 billion that would be made available by the Administration's plan to address the problems of insolvent thrift institutions is consistent with the amount that the FSLIC and outside observers estimate is needed. In addition, the regulatory and structural reforms included in the plan are intended to prevent a recurrence of the problem.

The Administration is presenting its proposal to Congress today.

C. The Appropriateness of Federal Assistance.

The appropriateness of any potential Federal assistance must be considered in the context of the statutory promise to the public to safeguard all Federally insured deposits.

In an insolvent savings and loan the value of the assets is less than the value of the liabilities. The latter are usually largely or entirely insured deposits. Since the FSLIC has promised insured depositors that they will remain whole, the FSLIC is obligated to make up this shortfall. And, since the Congress, in the Competitive Equality Banking Act of 1987, pledged the full faith and credit of the United States behind those insured deposits, the obligation is ultimately that of the Congress.

There are only two basic ways in which that obligation can be satisfied. One is to liquidate the insolvent thrift. The depositors are either paid off directly or their accounts are transferred to another thrift, while the assets are turned over to a government liquidating receiver. The second way is to find an acquirer for the insolvent thrift who will take over the obligations to the depositors (as well as the assets).

In this second case, because the value of the assets are less than the value of the deposit liabilities, the FSLIC must make a payment (or payments) to the acquirer to make up the shortfall in assets. Though this payment is technically called an "assistance" payment, it really represents the extent of the insolvency--an unavoidable obligation by the FSLIC. And, by law, the FSLIC cannot generally proceed with an "assisted" acquisition, as compared with a liquidation, unless the costs to the FSLIC of the "assistance" payment(s) are less than the cost of liquidation.

III. Budget and Policy Implications.

The budgets for the FSLIC and the Bank Board are part of the federal budget and, as such, can either contribute to or help diminish the federal deficit. Costs for addressing the financial difficulties of the S&L industry (case resolution costs) appear in the FSLIC budget. The FSLIC budget is included

-4-

in determining whether the federal budget will exceed Gramm-Rudman-Hollings deficit reduction levels; however, the FSLIC is exempt from the sequestration that would be triggered if federal spending exceeds target reduction levels.

The FSLIC budget outlays have been partially offset by inlays from recapitalization bond proceeds and miscellaneous other sources. Recapitalization bond proceeds appear as budget inlays because they are proceeds from a special 'financing corporation' and do not constitute additional federal borrowing. If the recapitalization proceeds were federal borrowing, then they could not be scored as inlays, and total net outlays and the federal deficit would correspondingly increase.

Beyond strict cash costs and obligations, two extraordinary items are counted as FSLIC outlays: (1) the full principal value of a note payable is counted as an outlay at the time the note is issued; subsequent principal payments on the note are not scored as outlays; and (2) a capital loss realized upon the disposition of an asset covered under some agreements is counted as an outlay at the time the loss is realized and claimed. Subsequent payment of the capital loss claim is not scored as an outlay. On the other hand, commitments to payments for future assistance (yield maintenance, indemnifications, etc.) are not scored as outlays until the time of payment, because of the uncertainties of the exact cost of future assistance.

Finally, in examining the budget impact of case resolution costs, the different impacts of acquisition versus liquidations should be considered. Generally, liquidations will have a larger initial budget outlay because of the up front cost of paying off insured depositors. Only years later, when the FSLIC's claim against the receiver is partially paid off, will budget inlays begin to offset the initial large outlay. Acquisitions, on the other hand, have smaller up front outlays because they only require a payment equal to the book negative net worth. The remaining cost(s) of "assistance" for an acquisition -- capital losses, indemnifications, yield maintenance, etc. -- are scored as outlays when they are incurred or paid off in subsequent years.

IV. Tax Provisions.

A. Prior Provisions (Expired: 12/31/88).

In 1981 Congress enacted certain tax provisions relating to the acquisition of troubled thrift institutions and the assistance provided by the FSLIC pursuant to such acquisitions. The purpose of the legislation was to place these acquisitions, which often involved mutual rather than stock associations, on a par with reorganizations of chapter 11 or similar stock corporations that could qualify for tax free reorganization treatment. The provisions as to the tax exempt nature of the FSLIC assistance payments was needed to clarify the treatment of these payments. In the absence of the provisions, arguments could be made to treat the assistance payments as either taxable income to the recipient thrift, capital contributions by a non-shareholder thereby requiring reduction in the basis of assets of the recipient, or as capital contributions by a shareholder requiring no reduction in the basis of the assets.

The Tax Reform Act of 1986 set an expiration date for these provisions of December 31, 1988. For transactions completed prior to that date and for later payments made pursuant to those transactions, the provisions mandated the following tax treatment:

1. Qualification of the acquisition as a tax-free reorganization permits the tax basis of the target's assets to carry over to the acquirer. The acquisition of a troubled thrift would be treated as a tax free reorganization if certain conditions were met. These conditions included the transfer of substantially all of the assets and liabilities of the target

-5-

thrift to the acquirer, a certification by the Bank Board that the target thrift would be insolvent in the near future, had dissipated substantial assets or earnings due to violations of laws, rules or regulations or unsafe or unsound practices, or was in an unsafe or unsound condition to transact business.

2. Pre-acquisition net operating loss carryforwards of the target thrift would be available for use by the acquiring thrift if a 20 percent continuity of interest test were met.
3. FSLIC assistance payments for losses, yield maintenance, indemnifications, and interest on FSLIC promissory notes are excludable from the taxable income of the recipient thrift.

The amount of benefits ultimately realized from these provisions is dependent upon: (1) taxable income being generated by the thrift subsequent to the acquisition; (2) limitations on the use of acquired tax attributes by other members of a consolidated group if the thrift is acquired by a holding company; and (3) application of the alternative minimum tax to the thrift.

The Bank Board has previously testified that the utilization of these tax benefits in acquisitions prior to January 1, 1989 produced a net reduction in the overall cost of case resolutions to the government, as well as a reduction in the cost to the FSLIC. We have provided greater detail on this issue in our answers to the specific questions asked by the Committee.

B. CURRENT PROVISIONS (Expire: 12/31/89).

In October, 1988, Congress passed the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). This legislation extended the provisions until January 1, 1990. However, Congress made certain changes to the provisions that were intended to cut back on the amount of the available tax benefits. This cut back appears to have been made in consideration of budgetary constraints facing the government rather than from a conceptual objection to the provisions, since at the same time Congress extended the tax provisions to bank acquisitions assisted by the FDIC.

The current provisions maintain the characterization of assisted acquisitions as tax-free reorganizations, the carry forward of the target's NOLs, and the exclusion of FSLIC assistance payments from taxable income of the recipient thrift. However, certain tax attributes of the acquirer are reduced by 50 percent of the amount of FSLIC assistance transferred in a taxable year (the 50% disallowance provision). This reduction is applied first to reduce pre-assistance net operating loss carryforwards, second to reduce interest expense deductions in the taxable year in which the assistance is received, and third to reduce the built in portfolio losses recognized in the taxable year in which the assistance is received.

The effect of this 50 percent disallowance rule is to reduce the tax benefits inherent in an assisted acquisition. In fact, when the effect of this rule is combined with the effect of the alternative minimum tax the benefits may be reduced by much more than 50 percent.

C. Separate Return Limitation Year "SRLY"

In some thrift acquisitions the thrift may become a member of a consolidated group of corporations. A frequent pattern used is that of a holding company, where the thrift is a subsidiary of the holding company, and the holding company engages in other activities and/or has other non-thrift subsidiaries.

In an acquisition of a thrift into a consolidated group certain rules exist to limit the utilization of the thrift's tax attributes by other members of the consolidated group. These rules are commonly referred to as separate return limitation year ("SRLY") rules, so named because of the limitation they place on tax attributes generated in a year in which the thrift was not a member of the consolidated group. These rules are not unique to thrift acquisitions, but apply to all consolidated groups of corporations.

Net operating loss carryforwards at the date of acquisition are considered to be generated in a separate return limitation year and are never available to offset income of any other member of the consolidated group. Even if the thrift meets the 20 percent of deposits test at the thrift level, SRLY NOL's are only available to offset income generated within the thrift itself. This is true even in the case where subsidiaries may be set up under the thrift at some later date. The income of the subsidiary may not be offset by SRLY NOL's of the thrift.

Built in losses are also subject to a SRLY rule unless, at the acquisition date, they are less than 15 percent of the tax basis of certain assets (the "15% de minimis test"). If the built in losses are considered de minimis, then they may be used to offset taxable income of other members of the group, but only to the extent that they are first used to offset taxable income of the thrift itself.

SRLY rules do not apply to limit the use of FSLIC assistance exclusions by other members of the group. FSLIC assistance payments are excludable from taxable income of the thrift. To the extent that this causes the thrift to generate negative taxable income, then the loss can be utilized to offset income of other members of the consolidated group.

CONCLUSION

Much has been done at the Bank Board and the FSLIC to resolve the myriad of problems faced in July 1987 when I assumed Chairmanship. With the new financing authority in CEBA, we were able to resume case resolutions, completing 21 resolutions from August 1987 through year-end 1987. In that same period of time, we promulgated the eight new regulations mandated by CEBA to strengthen our regulatory posture. Since January 1988 we have engaged in a very aggressive year-long-effort to resolve even more cases. Focusing on the largest and most troubled institutions, we were able to resolve 60 of the worst 100 institutions insolvent under Regulatory Accounting Principles.

The estimated cost of resolving cases that are known to us at this time is \$75 to \$80 billion on a discounted present value basis. This estimate includes only future assistance and unpaid commitments (including outstanding notes) already entered into that can be reasonably estimated at this time, and is not a projection of the cost of resolving all future problems in the savings and loan industry.

The budgets for the FSLIC and the Bank Board are part of the Federal budget and, as such, can either contribute to or help diminish the Federal deficit. Costs for addressing the financial difficulties of the savings and loan industry (case resolution costs) appear in the FSLIC budget. The FSLIC budget is included in determining whether the Federal budget will exceed Gramm-Rudman-Hollings deficit reduction levels; however, the FSLIC is exempt from the sequestration that would be triggered if Federal spending exceeds target reduction levels.

Tax benefits are an additional asset inherent in a transaction that can make the target thrift more attractive to an acquirer and thereby reduce the assistance that must be offered by the FSLIC to induce its acquisition. These benefits provide a valuable tool in light of the limited available resources. In the past, we recommended the extension of these provisions, as originally enacted in 1981, for a limited period

-7-

of time. However, the continued need for these provisions must be balanced against the adequacy of the funds appropriated or otherwise committed by the Congress to resolve the financial crisis of the savings and loan industry.

REGULATORY ENHANCEMENTS

Much has been done to ensure that the degree of problems experienced by the thrift industry will not happen again.

I. New Regulations have significantly strengthened our regulatory ability since 1985.

A. Equity Risk Investment Regulation

- Rule adopted in 1985 (and further strengthened in 1987); limited investments on the basis of a thrift's tangible capital.

B. Growth Regulation

- Rule adopted in 1985 to limit growth to 12-1/2% over any two (2) consecutive quarters. Policy strengthened last year (September) to prohibit asset growth by insolvents and limit growth by troubled institutions to amount equivalent to interest credited. Asset growth for industry, which averaged 19% in 1984 fell to 7.5% in 1987 and was 7.7% per annum through the third quarter of 1988.

C. Classification of Assets

- Enabled examiners to classify problem assets using the same procedures as banking agency examiners (12/85 and revised under CEBA).

D. Uniform Accounting Practices (Adopted as part of CEBA)

- Requires industry to adopt GAAP accounting by 1/1/91.

E. Proposed Trading versus Investment Policy Statement

- Would establish more accurate criteria for reporting value of investment securities and loans. (6/88)

F. Minimum Capital Regulation

Rule adopted in 1985 (and strengthened in 1987) phases in 6% capital-to-liabilities requirements. Median GAAP capital-to-total assets ratio, which was 3.3% in 1984, was 5.2% in September 1988.

- G. Individual Minimum Capital Requirement
 - Authorizes PSA to set Capital Requirements higher than the regulatory minimum on the basis of risk. (12/87)
 - H. Capital Directive
 - Provides for issuance of formal directives requiring increased capital. (12/87)
 - I. Proposed Risk Based Capital Regulation
 - Establish a more conservative capital requirement requiring an average of 8% capital against risk weighted assets including explicit recognition of interest rate risk. (12/88)
 - J. Proposed Early Intervention Proposal
 - Enhances ability of regulatory staff to act promptly when a minimum level of capital (1.5% GAAP) is not maintained. (12/88)
- II. Our Regulatory Initiatives are Designed to Ensure the Significant Level of Problems Do Not Recur
- A. Quantity of Regulatory staff has doubled.
 - 1093 in 1985 to approximately 2100 today.
 - B. Quality of staff dramatically improved.
 - 32% of new examiners have had previous experience.
 - 16% of examiners have advanced degrees.
 - Directors of Agency Functions and ORA Senior Staff include: the former director and the former associate director of Bank Supervision of the FRB. Former Acting Senior Deputy Comptroller of the Currency for Supervision, Chief and Assistant Chief National Bank Examiner, 3 Deputy Comptrollers, a Big 8 Accounting Partner; and Senior Staff from OMB, the OCC, FRB and FDIC.
 - C. Training has been enhanced and increased.
 - Mandatory core training curriculum for examiners has been implemented.

- Training days per professional has increased by 74% since 1985.
- D. National Accreditation Program for Examiners and Supervisory Agents effective 1989.
- E. Revised Regulatory Handbooks for examiners and supervisors issued in 1988.
 - Focuses on evaluating risk in Institutions, Holding Companies, and Service Corporations.
 - Uses a top down approach of evaluating management, policies, procedures, and controlled audit.
 - Emphasis on safety and soundness.
- F. Thrift Bulletin sets requirements for investing in mortgage derivative.
 - Establish standards for prudently investing in mortgage derivatives and restricts under capitalized and unsophisticated institutions from engaging in certain activities. (9/88)
- G. Peer Review Program with quarterly performance reviews established by ORA over District operations.
- H. National capital markets examination team being formed to examine capital market activities of large thrift institutions.
- I. Comprehensive Interest Rate Risk program being implemented to assist Industry in managing its interest rate risk.
- J. National Shared Credit Program being implemented.
- K. Uniform classification of high yield bonds program established.
- L. Service Corporation Report revised and enhanced.

M. DANNY WALL, CHAIRMAN
FEDERAL HOME LOAN BANK BOARD

WRITTEN RESPONSES TO QUESTIONS POSED IN THE
FEBRUARY 9, 1989 LETTER FROM CHAIRMAN ROSTENKOWSKI

Question # 1:

"What are the revised estimates of the tax benefits of 1988 case resolutions? Please provide these on a deal-by-deal basis. Please also show the actual dollar amount in each year as well as your present value analysis."

ANSWER:

The Federal Savings and Loan Insurance Corporation's ("FSLIC's") estimate of the tax benefits over ten years associated with the calendar year 1988 case resolutions amounts to \$5.5 billion in present value terms. The attached Table 1 is the FSLIC's estimate of these tax benefits on a deal-by-deal basis and the amount of such benefits each year through 1998.

Table 1
Page 3 of 9

[illegible]

[illegible]

[illegible]

Table 1
Page 9 of 9

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	TOTALS	PRESENT VALUE
SH-020 CFSB CORP													
TAX BENEFIT	50,394	51,766	51,766	51,766	51,766	55,297	49,276	43,302	32,589	16,331	16,311	447,497	298,735
ASS'N SHARE OF TAX BENEFITS	37,795	37,795	37,795	37,795	37,795	36,367	36,367	32,477	28,517	12,248	12,233	324,849	216,669
FSLIC's SHARE OF TAX BENEFITS	12,599	13,971	13,971	13,971	13,971	18,930	12,910	10,825	8,172	4,083	4,078	122,649	82,065
SH-021 UTLEY FORD													
TAX BENEFIT	235,844	341,636	298,311	298,311	260,761	244,371	215,714	191,780	201,433	233,485	236,845	2,460,180	1,564,013
ASS'N SHARE OF TAX BENEFITS	166,478	241,155	210,572	210,572	184,067	172,497	152,268	135,374	149,562	185,902	193,164	1,791,139	1,126,713
FSLIC's SHARE OF TAX BENEFITS	69,366	100,481	87,738	87,738	76,695	71,874	63,445	56,406	51,771	47,583	43,681	669,040	437,250
SH-022 PACIFIC USA													
TAX BENEFIT	7,655	12,133	12,020	12,020	16,034	16,290	21,984	26,720	16,951	17,353	20,190	167,340	96,934
ASS'N SHARE OF TAX BENEFITS	5,741	9,100	9,018	9,018	12,026	12,217	16,466	20,040	15,713	13,015	15,140	126,295	71,713
FSLIC's SHARE OF TAX BENEFITS	1,914	3,033	3,005	3,005	4,009	4,072	5,499	6,680	4,238	4,338	5,047	41,045	25,221
SH-023 CENTEX CORP													
TAX BENEFIT	17,725	18,769	18,430	18,430	19,247	18,190	16,645	15,062	12,058	18,281	25,550	177,958	109,113
ASS'N SHARE OF TAX BENEFITS	13,645	14,509	14,163	14,163	15,011	13,912	12,489	11,091	8,356	11,054	18,281	111,054	63,422
FSLIC's SHARE OF TAX BENEFITS	4,080	4,260	4,267	4,267	4,236	4,278	4,156	3,971	3,702	7,226	7,269	66,904	45,691
SH-024 LOCAL FSLA													
TAX BENEFIT	404	14	306	306	486	475	475	509	544	582	623	4,418	2,524
ASS'N SHARE OF TAX BENEFITS	404	14	306	306	486	475	475	509	544	582	623	4,418	2,524
FSLIC's SHARE OF TAX BENEFITS	0	0	0	0	0	0	0	0	0	0	0	1,665	1,283
SH-025 HYPERION PTR, LP													
TAX BENEFIT	6,379	1,903	3,488	3,488	6,787	4,701	5,030	5,383	5,759	6,072	6,462	51,965	31,102
ASS'N SHARE OF TAX BENEFITS	4,253	903	1,788	1,788	3,987	3,701	3,354	3,588	3,840	4,048	4,308	30,770	18,137
FSLIC's SHARE OF TAX BENEFITS	2,126	1,000	1,700	1,700	2,800	4,000	1,677	1,794	1,920	2,024	2,154	21,195	12,965
SH-026 NORTHWEST FEDERAL													
TAX BENEFIT	0	0	315	315	527	1,101	1,161	1,234	1,308	1,385	1,481	8,512	4,376
ASS'N SHARE OF TAX BENEFITS	0	0	315	315	527	1,101	1,161	1,234	1,308	1,385	1,481	8,512	4,376
FSLIC's SHARE OF TAX BENEFITS	0	0	0	0	0	0	0	0	0	0	0	0	0
TOTALS FOR 1988 CASES (1)	26.4	1,080.9	1,112.4	1,024.2	981.7	946.7	783.5	684.1	652.8	695.8	651.3	8,519.8	5,539.5
TAX BENEFITS OF TAX BENEFITS	9.1	441.6	530.9	486.6	467.0	406.2	396.4	359.8	340.1	390.1	346.0	4,218.1	2,680.8
ASS'N SHARE OF TAX BENEFITS	17.3	619.7	581.5	537.7	514.7	440.9	387.6	324.8	307.1	305.6	266.9	4,903.9	2,858.7

(1) TOTALS ARE IN MILLIONS

Question # 2:

"In choosing the method by which to resolve cases, the FSLIC by statute is required to choose between liquidation and a FSLIC-assisted merger on the basis of whichever is least costly. Does the revenue cost of tax benefits figure into that calculation in every transaction? Please provide documents showing this calculation in each of the December, 1988 case resolutions."

Answer:

In determining whether the cost of resolution for an individual case is less than the cost of liquidation, the FSLIC generally did not formally consider, nor was there any requirement to do so, the loss to the Treasury. The law requires that the FSLIC compare the cost of resolution to the FSLIC with the cost of liquidation (see discussion below). However, in those cases in which we believed that tax benefits would be significant, we did include the Treasury's revenue loss in our deliberations concerning our possible courses of action.

A. "Least Cost" Solutions.

The only legal restrictions on the cost of resolving a failing institution's problems are set forth in Sections 406(f) and 408(m) of the National Housing Act, as amended ("NHA"), 12 U.S.C. Sections 1729(f) and 1730(m) (1982), as amended. Section 406(f) of the NHA authorizes the FSLIC to provide financial assistance to failing insured institutions and to other entities or persons in order to prevent the default of, or to facilitate the merger or acquisition of, such failing institutions. Section 406(f)(4)(A) of the NHA states that no financial assistance shall be provided pursuant to Sections 406(f)(1), (2) or (3) in an amount exceeding that "which the Corporation [FSLIC] determines to be reasonably necessary to save the cost of liquidating (including paying the insured accounts of) such insured institution" Section 406(f)(4)(A) provides an exception to this restriction if FSLIC determines that the continued operation of the institution is essential to provide adequate savings or home financing services in its community. A similar restriction applicable to net worth certificates, but without the aforementioned exception, appears in Section 406(f)(5)(G).

Section 408(m) of the NHA allows the FSLIC to authorize the acquisition of a failing institution "[n]otwithstanding any provisions of the laws or constitution of any State or any provision of Federal law," except as provided in Sections 408(c), 408(e)(2) and 408(1). As a prerequisite to the exercise of such authority, the FSLIC must determine "that such authorization would lessen the risk to the Corporation [FSLIC]". In addition, as one of several additional prerequisites, the FSLIC must consider the need to minimize the cost of the FSLIC assistance. In so doing FSLIC must also consider the need to maintain specialized depository institutions as well as the priorities set forth in paragraph (B), (C) and (D) of Section 408(m)(3).

The literal language of Sections 406(f) and 408(m) of the NHA requires the FSLIC consider only the cost or amount of the FSLIC financial assistance in making its determinations. Furthermore, the language and legislative history of Sections 406(f) and 408(m), the Economic Recovery Tax Act of 1981, the Tax Reform Act of 1986 and the Technical Corrections and

Miscellaneous Revenue Act of 1988 do not in any way suggest that, in calculating the cost of resolution, the FSLIC must take into account revenue which the Treasury would have received but for the tax savings made possible by the provisions in these Acts concerning tax-free reorganizations and the FSLIC assistance payments.

Notwithstanding the forgoing, the aggregate costs of the FSLIC's 1988 transactions, inclusive of the tax revenues lost to the Treasury as a consequence of the tax benefits, were less than the costs of liquidation. This is shown in Table 2. As can be seen, the estimated savings were over \$4.6 billion. It is worth noting that the realistic alternative in most of these transactions was continued operation of the insolvent thrift, since the cash resources for widespread liquidations were not at hand. But continued operation would have meant the continued operating losses of these insolvents and the bidding up of deposit interest rates, raising the costs of funds for themselves and their neighbors. These additional benefits to completing these transactions are not included in the \$4.6 billion estimate.

Further, in 79 of the 85 individual transactions in 1988, the inclusive costs of the transactions were less than the estimated costs of liquidation. For the remaining 6 transactions, the cost "over-runs" were small in absolute and/or percentage terms and could be justified by the unmeasured benefits just discussed.

Though it is true that the FSLIC did not explicitly consider the Treasury's lost revenues in every transaction, the FSLIC was cognizant of these lost revenues in those transactions where they were likely to be relatively large, especially toward the end of the year. And, as Table 2 indicates, the aggregate costs of these transactions were less than the costs of liquidations.

B. Cost of Resolution Estimates:

Cost of Liquidation v. Cost of Solution
December, 1988 Case Resolutions.

The attached Table 1 is the FSLIC's comparison of the estimated cost of liquidation to the estimated cost of solution, inclusive of the total foregone tax revenues, associated with the December, 1988 transactions. As was true of the entire year's transactions shown in Table 2, the December transactions in aggregate were less costly than the costs of liquidation; and this was true individually for 31 of the 34 separate transactions.

Table 2
Page 1 of 2ESTIMATED TAX BENEFITS
Cases Processed From 1/1/86 to 12/31/86
(In millions)

CASE #	ACQUIRER	1 NET PV OF COST OF SOLUTION	2 ADJUSTED NPV OF COST OF SOLUTION	3 AGGREGATE TAX BENEFITS OF ACQUIRER, PWB.	4 IMPUTED COST OF SOLUTION	5 ESTIMATED COST OF LIQUIDATION	6 NET SAVINGS OF SOLUTION
C-322	Home FSLA	13.1	13.0	0.9	13.9	13.8	(0.1)
C-323	Atlantic Financial	81.5	69.5	12.0	81.5	107.1	25.6
C-324	Great West SB	3.3	3.3	0.0	3.3	5.9	2.6
C-325	Statebank FSB	154.1	193.2	23.5	176.8	207.1	30.3
C-326	Sterling SA	15.8	15.2	1.9	17.2	20.8	3.6
C-327	Lemon FSB	6.5	6.5	0.0	6.5	9.6	3.1
C-328	Home FSLA	7.1	7.1	0.3	7.4	10.5	10.8
C-329	Bariton Valley SLA	72.1	72.1	8.6	83.5	105.3	24.8
C-330	Eureka FSLA	303.5	263.5	44.8	308.3	395.9	87.6
C-331	First SA	9.5	9.3	0.8	10.0	10.3	0.3
C-332	Security First	9.6	9.1	0.9	10.0	12.6	2.6
C-333	Banktop FSLA	4.0	3.8	0.2	4.0	17.5	13.5
C-334	Eureka FSLA	9.3	9.3	1.0	10.3	13.1	2.8
C-335	World SLA	6.0	4.7	1.9	4.7	10.9	4.2
C-336	Coastal Banc	141.1	135.0	6.1	141.1	156.3	15.2
C-337	Southeast SA	2,115.3	2,102.3	13.0	2,115.3	2,502.7	387.4
C-338	River Valley FSB	34.2	33.9	5.1	39.0	45.0	6.0
C-339	Rock Valle SB	17.8	17.8	0.0	17.8	20.9	3.1
C-340	First FSB	14.2	13.7	1.2	14.9	19.8	4.9
C-341	United Savings	2.7	2.7	0.0	2.7	8.7	6.0
C-342	Standard FSLA	16.7	16.6	0.1	16.7	48.1	31.4
C-343	First FSB	12.2	12.2	0.0	12.2	19.3	7.1
C-344	Metropolitan FSB	299.0	299.0	1.6	300.6	414.6	114.0
C-345	Washington Federal	2.4	2.4	0.0	2.4	5.9	3.5
C-346	Old State Bank	49.1	39.6	5.3	45.0	65.2	20.2
C-347	Security First FSLA	17.1	16.9	0.1	17.1	20.1	3.0
C-348	First FSB & Trust	(0.3)	(0.6)	0.1	(0.5)	12.9	13.4
C-349	NE Bancshares INC	24.4	24.4	0.4	24.8	32.5	7.7
C-350	United Savings	3.6	3.6	0.0	3.6	10.5	6.9
C-351	Secur FSB	13.0	12.9	0.1	13.0	15.3	2.3
C-352	Washington FSLA	565.8	565.8	6.0	571.8	700.1	128.3
C-353	Home Federal SLA	5.0	5.0	0.0	5.0	10.3	5.3
C-354	Union FSB	35.0	34.7	2.7	37.4	44.9	7.5
C-355	Batterfield SLA	281.2	281.2	11.2	292.4	336.6	44.2
C-356	1st Federal Bank	8.4	8.4	1.7	8.7	10.1	0.3
C-357	American SB	5.7	5.7	0.0	5.7	17.8	4.4
C-358	First FSB of Indiana	3.0	2.8	0.6	3.4	7.9	4.5
C-359	Republic SB	28.8	28.8	3.8	32.6	30.2	(2.4)
C-360	New Peoples FSB	25.2	21.9	3.8	25.8	28.0	2.2
C-361	Crescent Savings FS	34.9	34.1	1.8	35.9	70.0	34.1
C-362	1st National FSB	11.8	11.8	0.0	11.8	25.1	13.3
C-363	1st National FSB	148.7	148.7	8.2	156.9	224.2	67.3
C-364	Flagship FSLA	21.8	23.8	0.0	23.8	29.3	5.5
C-365	Liberty FSB	10.3	10.2	0.3	10.6	14.7	4.1

Table 2
Page 2 of 2ESTIMATED TAX BENEFITS
Cases Processed From 1/1/88 to 12/31/88
(In millions)

CASE #	ACQUIRER	1 NET PV OF COST OF SOLUTION	2 ADJUSTED MPV OF COST OF SOLUTION	3 AGGREGATE TAX BENEFITS OF ASSTT. PRIS.	4 IMPUTED COST OF SOLUTION	5 ESTIMATED COST OF LIQUIDATION	6 NET SAVINGS OF SOLUTION
SA-004	American Fed. Bank	1,313.8	946.1	348.8	1,314.9	1,518.8	203.9
SA-006	Herbald of Texas	649.3	555.9	131.2	647.1	722.1	35.0
SA-013	First Heights FIA	1,102.0	907.5	294.7	1,206.2	1,274.5	44.3
SA-015	Guaranty FSB	1,489.1	1,461.8	119.5	1,581.2	2,170.0	588.8
SA-016	Franklin Fed. Bancorp	999.5	956.1	43.4	999.5	1,043.0	43.5
SA-017	Bankway S&LA	1,320.8	1,273.4	79.0	1,352.4	1,648.2	315.8
SA-018	Americity Fed. Sav.ing	160.8	155.7	5.1	160.8	158.3	(2.5)
C-347	Early Invest. Grp.	14.0	14.0	0.3	14.3	33.1	18.8
C-348	1st Western	2.0	2.0	0.0	2.0	8.7	6.7
C-349	Pacific First Bl.	187.5	145.0	37.9	182.9	241.6	58.7
C-370	First FSLA	19.5	19.5	2.9	22.2	22.5	0.3
C-371	Golden West	90.7	89.6	12.2	101.8	110.1	8.3
C-372	First Nationwide	118.3	118.3	23.9	142.2	251.1	108.9
C-373	Citizens Hig	20.3	17.6	2.7	20.3	35.7	15.4
C-374	Bay Financial	86.4	83.8	11.0	74.7	142.5	67.8
C-375	Bay Financial	13.5	13.5	1.6	15.1	102.9	87.8
C-376	Equiwest	145.8	137.7	11.3	148.9	201.8	52.9
C-377	Bankett Bank	4.9	4.3	0.6	4.9	30.8	25.9
C-378-B	Bank Group	1,699.0	1,699.3	874.7	2,570.2	3,333.0	762.8
C-380	Citizens FSB	187.9	182.4	5.9	190.3	253.1	62.8
C-381	Jackson County	62.5	62.7	5.8	72.4	86.7	14.3
C-382	Community Holdings	54.8	54.7	5.4	60.1	79.3	19.2
C-383	First Nationwide	1,486.5	1,486.5	648.9	2,333.4	2,430.7	97.3
C-384	Metropolitan FB	59.4	59.4	13.2	72.6	72.6	2.7
C-385	Western FSLA	11.4	10.3	1.3	11.4	22.9	11.5
C-386	Home Federal	243.3	253.8	31.2	285.0	320.4	35.4
C-387	South East Holding	29.0	29.0	0.0	29.0	234.5	205.5
C-388	Golden West	978.3	868.4	182.8	1,051.4	1,026.9	(24.5)
C-389	Coast to Coast	385.1	385.1	49.4	434.5	462.2	27.7
C-390	First Network SB	33.8	40.9	5.9	44.8	61.4	(27.6)
C-391	River Valley SB	17.4	13.9	3.5	17.4	30.3	12.9
C-392	Cal Fed.	151.1	139.8	37.6	177.6	184.7	7.1
C-393	Nichison National	983.1	1,031.5	158.5	1,189.9	1,181.2	(8.7)
C-394	Home FSLA	8.0	7.9	1.8	9.8	13.0	3.2
SA-020	CFSB Corp	1,846.3	1,775.4	298.7	2,074.1	2,117.0	42.9
SA-021	Utley Ford	5,046.4	4,913.3	1,564.0	6,477.3	6,822.3	345.0
SA-022	Pacific USA	566.2	542.0	96.9	638.9	662.2	23.3
SA-023	Centex Corp	374.5	328.8	109.1	437.9	443.7	25.8
SA-024	Local FSLA	89.0	87.7	2.5	90.2	145.2	55.0
SA-025	Hyperion Pfr., LP	1,372.2	1,365.2	31.1	1,396.3	1,492.0	95.7
SA-026	Northwest Federal	78.3	78.3	4.4	82.7	113.9	31.2
TOTAL		28,346.5	27,092.4	5,538.9	32,631.4	31,280.3	4,449.0

Table 3

ESTIMATED TAX BENEFITS
Cases Processed During December 1988
(in millions)

CASE #	ACQUIRER	1 NET PG OF COST OF DILUTION	2 ADJUSTED MPV OF GINT OF DILUTION	3 AGGREGATE TAX BENEFITS OF ACQIR., PNT.	4 IMPORTED COST OF DILUTION	5 EXTENDING COST OF AMINATION	6 NET SAVING OF DILUTION
C-367	Early Invest. Grp.	14.0	14.0	0.3	14.3	32.1	18.8
C-368	East Western	2.0	2.0	0.0	2.0	8.7	6.7
C-369	Pacific First Bk.	167.5	145.0	37.9	162.9	244.6	56.7
C-370	First FSLA	19.5	19.3	2.0	22.2	22.5	0.3
C-371	Golden West	90.7	89.4	12.2	101.8	116.1	8.3
C-372	First National	118.3	116.3	23.9	142.2	211.1	168.9
C-373	Citicorp Rtg	29.3	17.4	2.7	29.3	35.7	15.4
C-374	Hyun Financial	46.4	43.0	16.9	76.7	142.5	67.8
C-375	HMC Financial	13.5	13.5	1.6	15.1	182.9	87.8
C-376	EquiMark	146.8	137.7	11.3	149.0	201.8	52.8
C-377	Barnett Bank	4.9	4.3	0.6	4.9	30.8	25.9
C-378-9	Beas Group	1,699.0	1,699.5	874.7	2,579.2	3,333.0	762.8
C-380	Citizens FBO	187.9	186.4	5.9	190.3	253.1	62.8
C-381	Jackson County	42.5	42.7	9.8	72.5	86.7	14.2
C-382	Community Holdings	54.8	54.7	5.4	60.1	79.3	19.2
C-383	First National	1,684.5	1,666.5	648.9	2,333.4	2,830.7	97.3
C-384	Metropolitan FB	59.6	59.6	13.2	72.8	75.5	2.7
C-385	Western FSLA	11.4	10.3	1.4	11.7	22.9	11.2
C-386	Home Federal	263.3	253.8	31.2	285.0	320.4	38.4
C-387	South East Holding	29.0	29.0	6.0	29.0	234.5	205.5
C-388	Golden West	978.3	868.6	182.8	1,051.4	1,086.9	(26.5)
C-389	Coast to Coast	365.1	366.1	49.4	434.5	462.2	27.7
C-390	First Network 18	33.8	44.9	5.9	44.8	41.6	(3.2)
C-391	River Valley 18	17.4	13.9	4.0	17.9	30.3	12.4
C-392	Cal Fed.	151.1	139.0	37.8	177.6	186.7	7.1
C-393	Michigan National	983.1	1,031.5	156.5	1,190.6	1,381.2	(6.0)
C-394	Home FSLA	8.0	8.0	1.8	9.8	13.0	3.2
BA-020	CFSA Corp	1,846.3	1,775.4	290.7	2,076.1	2,117.0	42.9
BA-021	Utley Ford	5,046.4	4,913.3	1,544.0	6,477.3	6,622.3	345.0
BA-022	Pacific USA	566.2	542.0	94.9	636.9	662.2	23.3
BA-023	Centex Corp	374.5	328.8	109.1	437.9	443.7	23.8
BA-024	Local FSLA	89.9	87.7	2.5	90.2	145.2	56.0
BA-025	Hyperion Pfr., LP	1,372.2	1,245.2	31.1	1,396.3	1,496.0	99.7
BA-026	Northwest Federal	78.3	78.3	6.4	82.7	113.9	31.2
		16,625.6	16,238.2	4,261.7	20,479.8	22,775.1	2,295.3

Question # 1:

"With respect to Question 2, in making this determination, do you assume that the going-concern values have any value in the liquidation?"

Answer:

The going concern value, if any, of a thrift is largely the value inherent in its core deposit base. In a liquidation accomplished by a transfer of accounts, this value, if it exists, is captured by the FSLIC by paying the association that assumes the accounts an amount less than the total outstanding balance of such accounts. This discount represents the going concern value inherent in the accounts. In a liquidation analysis, the FSLIC ascribes a value only to assets that have a sales value, which are for the most part tangible assets. The only intangible assets that are ascribed a value are those such as loan servicing, which would likely be purchased by a competitor from the receiver. Most intangibles will have no value in a liquidation.

We do not normally estimate the benefit to the FSLIC of a potential premium on the transfer of deposits in liquidation. However, the Board considers the existence of such benefits in its decision making process.

Question # 4:

"With respect to question 2, has the Board always included tax benefits in its calculations? If not, when did the Board begin to include tax benefits in its calculations?"

Answer:

The Board has always been aware of tax benefits as an asset that can be used to reduce the FSLIC's costs of resolving an insolvent thrift. Because, typically, the magnitudes of the tax benefits were small and did not appear to make a difference in the cost comparisons between liquidation and an assisted acquisition, they were not included in the cost comparison presented to the Board. Prior to 1988, FSLIC agreements generally captured 100% of the tax benefits for the FSLIC.

However, when tax benefits represented a larger portion of the cost of some mergers, and in cases where potential tax benefit sharing with the FSLIC was critical to the determination of the least costly merger proposal of several competitive proposals, the FSLIC has attempted to quantify them. Further, in such instances the FSLIC has been cognizant of the estimated losses to the Treasury.

Question # 5:

"Is the value of the net operating losses to the acquiring corporation or entity included in your analysis of tax benefits? If not, please provide a detailed explanation for not taking these items in account. If so, please provide documents showing this calculation in each of the December, 1988, case resolutions."

Answer:

The revised estimate of tax benefits includes an estimate of the expected utilization of pre-assistance NOLs. Tables 1, 2 and 3 include these estimates in the total estimate of tax benefits for each case. The attached Table 4 is the FSLIC's estimate of the NOL utilization for each of the December 1988 case resolutions on an annual basis.

As a comparison of Table 3 and 4 indicates, NOLs are a relatively unimportant part of the total of tax benefits -- less than 4%.

Table 4
Page 4 of 4

SM-020 CONSOLIDATED FSM														
MOL's Used	0	25.00%	0	25.00%	0	25.00%	0	25.00%	0	25.00%	0	25.00%	0	0
Sharing Percentage	25.00%	0	0	0	0	0	0	0	0	0	0	0	0	0
FSLIC's Share	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Association's Share	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SM-021 WILEY FORD														
MOL's Used (MRT Only)	0	10.00%	0	10.00%	0	10.00%	0	10.00%	0	10.00%	0	10.00%	0	0
Sharing Percentage	10.00%	0	0	0	0	0	0	0	0	0	0	0	0	0
FSLIC's Share (Regular Only)	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Association's Share	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SM-022 PACIFIC ELECTRIC WIRE CABLE														
MOL's Used	0	1,281	3,212	0	7,912	10,945	0	25,00%	0	25,00%	0	25,00%	0	28,300
Sharing Percentage	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%
FSLIC's Share	0	320	801	931	1,978	2,716	0	0	0	0	0	0	0	7,075
Association's Share	0	961	2,409	2,812	5,914	8,209	0	0	0	0	0	0	0	21,225
SM-023 CENTER CORPORATION														
MOL's Used	0	25.00%	0	25.00%	0	1,101	3,253	5,745	0	25,00%	0	25,00%	0	28,813
Sharing Percentage	25.00%	0	0	0	0	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%
FSLIC's Share	0	0	0	0	0	275	813	1,408	0	0	0	0	0	7,203
Association's Share	0	0	0	0	0	826	2,440	4,309	0	0	0	0	0	21,610
SM-024 LOCAL FSIA														
MOL's Used	0	100.00%	0	100.00%	0	497	531	569	0	100.00%	0	100.00%	0	2,856
Sharing Percentage	100.00%	0	0	0	0	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
FSLIC's Share	0	0	0	0	0	497	531	569	0	0	0	0	0	2,856
Association's Share	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SM-025 HEPERION PARTNERS LP														
MOL's Used	0	33.00%	0	33.00%	0	0	0	0	0	33.00%	0	33.00%	0	3,400
Sharing Percentage	33.00%	0	0	0	0	33.00%	33.00%	33.00%	33.00%	33.00%	33.00%	33.00%	33.00%	33.00%
FSLIC's Share	0	0	0	0	0	0	0	0	0	0	0	0	0	1,122
Association's Share	0	0	0	0	0	0	0	0	0	0	0	0	0	2,278
SM-026 NORTHWEST FSIA														
MOL's Used	0	0.00%	0	0.00%	95	143	491	691	0	0.00%	0	0.00%	0	3,594
Sharing Percentage	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
FSLIC's Share	0	0	0	0	0	343	491	691	0	0	0	0	0	3,594
Association's Share	0	0	0	0	0	0	0	0	0	0	0	0	0	0
TOTALS														
MOL's Used	5,847	1,789	3,671	6,089	9,350	20,397	22,823	42,508	92,466	114,169	310,737	142,980	14,284	1,341
Sharing Percentage	36.45%	26.23%	14.68%	13.33%	16.20%	26.12%	31.00%	16.80%	6.14%	0.34%	17.19%	11.28%	0.34%	2.856
FSLIC's Share	7,717	2,480	5,311	1,056	1,702	6,145	8,445	7,143	8,452	10,202	37,278	21,225	37,278	21,225
Association's Share	2,430	1,320	3,140	5,033	7,449	14,253	14,377	35,346	84,014	103,967	286,251	127,370	127,370	127,370

Question # 6:

"How does the Board negotiate with potential purchasers regarding potential tax benefits in a transaction? Please provide a specific case analysis referring to the so-called "Southwest" transactions of December, 1988."

Answer:A. Negotiations with Potential Purchases.

Tax benefits are, in essence, an additional asset inherent in a transaction that can make the target thrift more attractive to an acquirer and thereby reduce the assistance that must be offered by the FSLIC to induce its acquisition. This reduction in the FSLIC's costs of the transaction can occur through return of all or part of the tax benefits to the FSLIC or through better terms for the FSLIC on other parts of the assistance agreement--e.g., a larger share of the profits of or warrants in the resulting thrift, a lower cash payment by the FSLIC or a smaller FSLIC promissory note issued, a lower rate of interest on the FSLIC note, a lower rate of yield maintenance on certain assets, a greater amount of loss absorption by the acquirer, etc. The tax benefits received by the acquirer are not a windfall but are instead an integral part of the FSLIC's necessary payment to fill in the negative net worth "hole" of the insolvent thrift so as to facilitate its acquisition. If these benefits were not available, the FSLIC would have to make commensurately larger direct payment in some other form.

B. Southwest Plan.

In all transactions -- Southwest and non-Southwest alike -- the goal of the FSLIC negotiators has been to achieve least-cost transactions for the FSLIC. As noted above, the tax benefits are treated as another asset of the insolvent thrift, which can be used to reduce the FSLIC's costs. Depending on the potential acquirer's tax status, expectations about the use of the tax benefits, the severity of the problem inherent in the target institution, the attractiveness of the target in the market place, and flexibility on other terms of the assistance contract, the FSLIC negotiators might find that the lowest costs would be achieved by contracts that called for all, some, or none of the tax benefits to be explicitly rebated to the FSLIC; and contracts embodying the entire range were concluded by the FSLIC during 1988. To the extent that the FSLIC did not capture all of the tax benefits directly by contract, we feel that we recaptured them indirectly through more favorable terms in other parts of the contract.

In one widely discussed Southwest transaction, the Utley-Ford transaction (SW-021), the FSLIC is to receive one-third of all tax benefits (except NOLs) computed at a 30% tax rate, with guarantee of a minimum \$30 million per year. However, in this transaction, the FSLIC realizes its share of the tax benefits at the time an assistance payment is made. The Agreement provides for a reduction of any claims, including accrued interest payments on promissory notes, by an amount equal to the FSLIC's share of the tax benefits, resulting in a payment equal to 90% of the amount claimed. The realization of tax benefits in this manner produces a higher present value than other Southwest Plan transactions that provide for the FSLIC to receive tax benefits after the acquirer files its income tax return. As reflected on Table 1, the net savings to the Treasury over the cost of liquidation was \$345 million.

Question # 7:

"In the period preceding the passage of the Technical and Miscellaneous Revenue Act of 1988, representatives and staff of the Board argued that without extension of special reorganization rules for financially-troubled thrift institutions, the Board would have to resolve more cases through liquidation instead of assisted reorganization. If the special rules were not in place, how many of the FSLIC-assisted mergers which took place in 1988 would have been liquidations?"

Answer:

In August of 1988, FSLIC staff forwarded an analysis of all case resolutions consummated over a 14-month period ending February 28, 1988, to the staff of the Joint Committee on Taxation. The purpose of this analysis was to attempt to quantify the possible budgetary impact that would result absent the cost reductions to the FSLIC realized by the special tax provisions, or the incentives that accrue to acquirers through these provisions. Applying the same criteria to the 1988 resolutions, 6 of the 85 transactions might have resulted in liquidations instead of assisted acquisitions (approximately 7%). Total deposits of these 6 cases amounted to \$3.4 billion out of a total of \$85.6 billion (approximately 4%). The analysis provided in August 1988 reflected only one transaction that could have resulted in a liquidation, but the deposits of that case represented 7% of the aggregate deposits of the 28 cases resolved during the 14-month period.

Question # 8:

"With respect to question 7, what are the basic steps in the typical liquidation?"

Answer:

The basic steps in a typical liquidation involve the following:

A. The Insurance Division.

The Insurance Division has the responsibility for setting up the procedures which will allow for the transfer of funds from the insolvent institution to an acquirer, de novo, or depositors in the event of a cash pay-out. This involves considerable coordination by the case manager, who must arrange for meetings with the deposit accounts acquirer, assign accounting teams for the determination of insurance of accounts, contact the institution's service bureau for cooperation in providing the necessary financial reports, arrange for public confidence personnel to handle depositor questions, and coordinate with the Receivership Operations Branch to guarantee a smooth and efficient takeover.

B. The Receivership Operations Branch.

It then becomes the responsibility of the Receivership Operations Branch to arrange for the takeover activities and the resulting receivership once the FSLIC has control. This involves contracting for security personnel, press coverage, asset, loan and accounting teams to review the financial records of the institution, claims staff and priority letters personnel for the purpose of notifying businesses who have a working relationship with the institution. There is a great deal of logistical coordination, which requires the ability to handle a myriad of detail and to be cognizant of an ever-changing format. The acquirer receives the insured liabilities of the insolvent institution; the FSLIC as Receiver retains the non-performing loans, other assets and uninsured liabilities. In order to liquidate the assets and perform workouts of the loans, the establishment of a receivership office is necessary. This involves hiring personnel from the failed association, in conjunction with FSLIC as Receiver regional staff, to assist in managing loan portfolios and asset liquidation. A Managing Officer is appointed for the receivership. This officer who then becomes responsible for the day-to-day operation of the ongoing office transactions and procedures. Assets are marked to market through a sophisticated procedure of determining the net realizable value. The receivership either manages the assets or contracts with asset managers. Upon liquidation of these assets, liquidating dividends are paid to the creditors of the receivership, of which the largest by far is the FSLIC, as subrogee of the insured depositors.

Question # 9:

"Many commentators believe that managers of FSLIC-assisted thrift institutions that result from FSLIC-assisted mergers do not have adequate incentives to maximize returns of covered assets and, thereby, minimize the cost to the FSLIC. Is this true? Please provide us with provisions in representative contracts that ensure that managers will minimize FSLIC's cost."

Answer:

There are a number of provisions in FSLIC assistance agreements that ensure that acquirers will minimize the FSLIC's cost in disposing of Covered Assets. First, as a condition to receiving related assistance, several sections require the acquiring association to submit a detailed collection, property or business plan and budget for each substantial Covered Asset that is a loan, real estate owned or subsidiary corporation. These sections are extensive (they cover approximately 30 pages of a typical assistance agreement) and provide for FSLIC approval of both the plan and budget and of any deviations therefrom.

Second, the acquiring association covenants that it will (i) administer and deal with the Covered Assets employing the higher of the standard of prudent business practice used by the acquirer in administering its own assets not acquired from the target or the standard employed in the savings and loan industry generally and (ii) endeavor to minimize losses and maximize gains and recoveries. Breach of this covenant results in the loss of related assistance.

Third, the agreement provides that with respect to assets that have not been disposed of by the end of the agreement, FSLIC will make a payment to the acquirer at that time equal to the difference between their book value and their fair market value. However, this payment is to be made only if the acquirer has used its best efforts to dispose of the property during the term of the agreement.

Fourth, the FSLIC has the right to purchase any Covered Asset at any time.

The above four provisions provide significant assurance that the acquirer will attempt to maximize gain and minimize loss with respect to Covered Assets by subjecting the acquirer to potential loss of substantial assistance. In addition to the potential negative effect of imposing a loss on the acquirer, most agreements also provide a positive incentive to the acquirer by permitting it to retain a certain percentage of any gain realized upon the disposition of Covered Assets above a certain base price. In many agreements, the percentage increases as aggregate gains increase so as to provide a further incentive to maximize value.

Finally, in the acquisition of American Savings by the Robert M. Bass Group, Inc. a separate incentive agreement was executed to provide additional positive incentives. This agreement not only provides a percentage of gain realized upon the disposition of individual assets, but provides the opportunity to earn an additional percentage if the aggregate Covered Assets are disposed of at an aggregate gain. This additional provision encourages minimization of losses on the worst assets that cannot be expected to be disposed of at a price in excess of the base. The agreement also provides for similar incentives in dealing with restructured loans so as to remove any bias against restructuring a troubled loan and in favor of foreclosure.

Question #10:

"With respect to question 9, what type of incentives are most common?"

Answer:

All of the incentives discussed in the response to question #9 are commonly found in the Southwest Plan agreements, with the exception of the incentive agreement executed in the American Savings acquisition.

Mr. WHITE. Thank you, Dan.

Mr. Acting Chairman, to understand the tax provisions and how they were used, we have to go into a little more detail on the nature of the transactions and how they were carried out. Dan Wall has just given you a brief overview, but a number of questions have come up from your committee members as to how these transactions worked. I think I can provide a little greater information by handing out to you a set of diagrams that I provided to the committee staff a few weeks ago. I think that they illustrate the nature of the problem, what it means to be an insolvent savings and loan, what it means to be doing an assisted acquisition, what it means to be doing a liquidation. So, I would like to distribute these to you.

[The diagrams follow:]

SIMPLIFIED THRIFT ACCOUNTING

A. HEALTHY THRIFT

ASSETS	LIABILITIES
100 (LOANS)	92 (DEPOSITS, INSURED)
	----- 8 NET WORTH

B. MARGINAL THRIFT

ASSETS	LIABILITIES
92 (LOANS)	92 (DEPOSITS, INSURED)
	----- 0 NET WORTH

C. "DEEP YOGURT" THRIFT

ASSETS	LIABILITIES
60 (LOANS)	92 (DEPOSITS, INSURED)
	----- -32 NET WORTH

D. SOUTHWEST "DEEP YOGURT" THRIFT

ASSETS	LIABILITIES
60 (LOANS)	92 (DEPOSITS, INSURED)
(40)	----- -32 NET WORTH (-52)

Mr. GIBBONS. I don't want you all to talk too long, because I have a lot of questions.

Mr. WHITE. Well, I hope I will be able to answer a number of them.

Mr. GIBBONS. Get ready. I have enough of this junk. I will tell you, I look at you all and, you know, I do not want to send any of you to jail, but I had better not catch you, I will tell you, I grew up in an era in which to default a savings and loan or a bank meant jail sentences for the directors and the officers and I have not seen enough of that. I think we have been far too generous with this bunch of high-binders.

Mr. WHITE. I have a great deal of sympathy with what you are saying, Mr. Acting Chairman.

Mr. GIBBONS. I think you have got too many institutions. By the way, are you all still guaranteeing new institutions? You have got more of them than we have filling stations in my city. Really, come down to my city and count them, in Tampa, Florida. I have got more of them within half a mile of my house than I have got filling stations. The filling stations are all going broke; I do not know why the savings and loans and the banks are not going broke. They probably are.

Mr. WHITE. Part of our overall plan was to consolidate wherever possible and to reduce the number of thrift institutions.

Mr. GIBBONS. They are building a new bank right two blocks from my house. We already had five and we have a new one coming.

Mr. GIBBONS. You will have to talk to——

Mr. PICKLE. Mr. Gibbons, I say you are a little bit old-fashioned, because you keep referring to them as "filling stations."

Mr. GIBBONS. OK. Service stations or whatever they are—hamburger stands. [Laughter].

Come on, let us proceed, Mr. White.

Mr. WHITE. All right. The important thing to understand is that when you start with a healthy thrift, you are starting with assets that are greater than the liabilities, and the liabilities we are talking about are basically insured deposits. That is my example A.

Example B shows what happens when those assets have started to lose value and so you have assets that are just equal to the insured deposits. Finally, example C, we have an insolvent savings and loan in which the assets now are worth only 60. We still have the insured deposits worth 92, and so there is a negative net worth of 32. That means that there is a shortfall, someone is on the hook for that short-fall, because those deposits are insured.

In the first instance, it is the FSLIC, but ultimately it is the Congress, because it is the Congress that in 1987 said that the full faith and credit of the United States stands behind those insured deposits. We all wish we could go back in history and un-do all the things that happened to create this shortfall, which Dan Wall just mentioned, but——

Mr. GIBBONS. Did we say that or did we put it into law, or did the people who interpreted the law——

Mr. WHITE. It was in the Competitive Equality Banking Act of 1987.

Mr. GIBBONS. Is that the law or is that some staff's statement?

Mr. WHITE. It is in the law, title IX of the Competitive Equality Banking Act of 1987, said that it is the sense of the Congress that the full faith and credit of the United States stands behind—

Mr. GIBBONS. Well, that is a terrible mistake, because before that it had only been FSLIC's full faith and credit.

Mr. WHITE. Well, that statement had been made in 1982, as I recall, as well, Mr. Acting Chairman.

Now, once we have an insolvent savings and loan, there are basically three possible courses of action. The first is to simply let it continue in operation. It is not going to get any better; in fact, it is going to get worse, because losses are going to pile up in that savings and loan; an insolvent thrift of this magnitude cannot earn enough on its assets to pay its interest costs to its depositors and its other costs, and so losses will pile up. Further, it is going to have to bid up interest rates in order to attract deposits into this thrift. But, letting it continue to operate is a possible course of action. As you know, too many insolvent savings and loans were kept open for too long because of inadequate resources at the FSLIC.

The second is liquidation. In a liquidation the depositors are either paid off directly or their deposits are transferred to another savings and loan; the assets are sent off to a Government liquidating receiver, and we hope we can get the 60 back. Net, it is going to cost 32, because you paid out 92 to the depositors and you hope to get 60 back; net, it costs 32.

The third is to find an acquirer, and the first thing an acquirer is going to say is, "Hey, I'm taking over 92 of insured deposits, I owe those depositors 92 on the very first day of operation, and you're only giving me 60 in assets to cover those obligations. Uh-huh, I'm not going to take over an operation like that," Accordingly we have to give the acquirer something in the vicinity of 32 in order to provide him with enough assets, roughly 92 in assets, to cover the 92 in insured deposits that he owes to the depositors the very first day of operations.

If the transaction were just that straightforward, it would be a wash between doing liquidations and finding an acquirer, but there are a number of advantages to doing the transactions with an acquirer.

First, we do not have to provide all the cash up-front, we only have to provide limited amounts of cash, the difference between assets and liabilities. Second, acquirers are willing to take notes and guarantees, whereas, we would have to come up with cash in liquidations; notes would not be good enough.

Third, there is a franchise value to be preserved when we do an acquisition, and the acquirer is willing to take that into account. It is an off-balance sheet asset, which means that we have to come up with less cash or less assistance, a smaller note than would be true if we did the liquidation. Finally, the acquirer may be able to manage and dispose of the assets that we are leaving in the thrift at lower cost than would be true of a liquidating receivership. Liquidating receiverships are not costless. They are costly to run, they run up substantial expenses. The transactions we have been able to do with acquirers involved lower costs in terms of maintaining and managing and disposing of the assets.

Mr. GIBBONS. Well, that is yet to be set, really, but go ahead.

Mr. WHITE. Well, that is the way our contractual arrangements work; those costs are going to be less than would have been true in a liquidating receivership.

In essence, the acquirers in many of these transactions are managing the resources, managing the assets on behalf of the FSLIC. They will be getting pieces of the up-side, while the FSLIC will be getting the lion's share of the up-side. So if the geographic areas where these assets are located, mostly in the Southwest, do come back, the FSLIC will benefit greatly by having done these acquisitions in the way that we did them, with capital maintenance, asset maintenance, guarantees, and with capital loss coverage, yield maintenance guarantees. We will thereby have preserved the upside for the FSLIC and ultimately for the U.S. Government. This brings me to the fourth example, the Southwest-type transaction, where an asset may be thought to be worth, say, 60, but only 3 or 4 years from now. Consequently, we have to cover the transaction with yield maintenance and with capital loss coverage until the asset is sold 4 years later.

Now, I need to emphasize what Dan Wall just said: These are not bailouts, these are not rescues, because the shareholders, the owners, and the managers are "history" when we take over an insolvent thrift. When we find an acquirer, technically we close the place and then reopen it under new auspices, new management, and new capital. We send a squad of lawyers in to look over the records of the old management and the old owners, and we sue those old managers and those old owners wherever possible so as to try to recover at least some of the moneys. We make criminal referrals to the local U.S. attorney and hope they will get criminal indictments. So, these are not bailouts.

The amounts of money that we have to pay to acquirers. You sometimes read of them as subsidies. The term that we use, even within the agency, is "assistance payments," and we refer to these transactions as "assisted acquisitions". But as you can see from this example, this is not a subsidy. The FSLIC and ultimately the U.S. Government is on the hook for these negative net worths, for these insolvencies in these savings and loans. The money is going to have to get paid in one way or another. These are not subsidies.

Now, let me get to the tax matters. From the FSLIC's perspective, the potential tax benefits in an assisted acquisition is simply another asset; it is a way of reducing the FSLIC's costs of doing a transaction. The tax benefits allowed us to extend our limited resources much farther than otherwise would have been the case. They allowed us to do more transactions, to put more insolvents out of the picture, to stop the hemorrhaging. The hemorrhaging was going on at a rate of \$6 to \$7 billion of operating losses occurring throughout the industry, with \$4 billion of annual rate operating losses in the 205 institutions that we put out of the picture in 1988. These tax benefits allowed us to do more of these transactions.

The tax benefits are basically of three types: First is the net operating losses that accumulated in the institution before we do the transaction. They can be used only under limited circumstances in the thrift itself. For reasons I do not understand, these NOL's, as

they are called, have attracted a great deal of attention; but in fact they are by far the smallest amount of the tax benefits that are involved in these transactions.

We estimate that for the December transactions, the usage of the NOL's will account for less than 4 percent of the overall tax benefits used in these transactions.

The second category is that our assistance payments, both the initial payment and the subsequent payments, either capital loss coverage or yield maintenance payments, are considered nontaxable income. Finally, the interest on the FSLIC promissory notes that are issued in the transactions, is not considered reportable taxable income.

Let me emphasize, that these tax benefits are not received all in one lump sum at the beginning of the assisted acquisition. They are received only over time as the acquirer keeps the thrift in operation, keeps it healthy, keeps it well capitalized. We have strong protections in these arrangements so that if the thrift starts drifting down hill, we can take control of that thrift at an early stage and not have to endure the kinds of losses that the fund has endured in the past because it did not intervene early enough. We are going to have our supervisors, our examiners in the field watching these acquirers like hawks. This is not 1983 any more.

Now, we have made the estimates of the aggregate amounts of these tax benefits that the committee has asked for in terms. For all of the transactions of 1988, we estimate that, on a present value cost basis, the aggregate amount of the tax benefits, in essence the lost revenues to the Internal Revenue Service, came to \$5.5 billion. That is on a present value cost basis. For the December transactions alone, they came to \$4.2 billion.

Now, through our contractual arrangements in these assisted acquisitions, we got explicitly back roughly 50 percent of these tax benefits, explicitly reducing the amounts of payments that we will be making. Further, because of the availability of these tax benefits we believe that we got better terms on the other features of the contracts: the size of the note, the size of the cash payment, the interest on the note, the interest on the yield maintenance, the amount of loss sharing.

So, we believe that the right way to judge these transactions is their aggregate cost to the Government inclusive of all the foregone tax revenues to the Internal Revenue Service.

We have made that estimate. For all of 1988 the savings to the Federal Government, inclusive of the tax benefits, by doing these transactions, rather than going through liquidations, was \$4.6 billion. The Federal Government saved \$4.6 billion by doing these transactions, including the lost revenues to the IRS, rather than going through liquidations. For the December transactions alone, the figure was \$2.3 billion.

If you look at the transactions on a transaction-by-transaction basis, in 1979, of the 85 transactions that we concluded in 1988, the cost to the Government was less than the cost of liquidation, inclusive of all these tax benefits. For the remaining 6, the cost overrun was relatively small in percentage terms, and/or in absolute terms. We believe that the slight overrun in these 6 cases is more than justified by the cutting off of the operating losses that occurred by

doing these transactions and by the lowering of interest rates for all of the surrounding thrifts that occurred when we are able to provide acquirers and thereby replace an insolvent thrift with a well-capitalized thrift.

In addition, we have introduced flexibility into these contracts, so that the notes that have been issued can be called and the covered assets can be called. If at some future time the FSLIC wishes to use its cash so as to call those notes or those covered assets, and thereby reduce the amounts of future tax benefits which would otherwise occur, that flexibility is there. That would be an understood and perfectly acceptable part of those contracts.

In summary, I would agree with many of the positions that have been expressed by the committee members and by the committee staff, that, as a general proposition, the indirect use of tax moneys through tax benefits is frequently a less efficient and less desirable way of achieving policy goals than are direct budgetary allocations.

But we did not have those direct budgetary allocations, and we did have hundreds of insolvent savings and loans who were bleeding, who were hemorrhaging, who were running up operating losses that were simply going to add to the future costs of dealing with these insolvents; and the Congress had made these tax benefits available to the FSLIC in 1981 and had reviewed them in 1986.

I believe that, given all of these circumstances, we have behaved responsibly in entering into these transactions and that the Government's money was well spent.

We have answered in written form the specific questions that the chairman asked and we will be happy to provide any further explanation or detail on those answers.

Chairman ROSTENKOWSKI. Mr. Gibbons.

Mr. GIBBONS. Well, if I believe you all—and I may, but I am not sure—I would have to say that the General Accounting Office does not know what they are talking about. Is that not a logical conclusion?

Mr. WALL. I do not think that we are in direct conflict with the General Accounting Office. The General Accounting Office is, as accountants do, taking a very pessimistic view, the glass is half empty, not half full. We are taking a more pragmatic view in terms of what the prospect is for recovery of the market, for example, in Texas. The question is not whether or not Texas will recover, the question is when. We have provided in the Southwest contracts for a 10-year timeframe within which that market recovery can be recognized and benefit the insurance fund, whether it be FSLIC or its successor.

There was a good deal of discussion earlier in terms of whether or not the problem is distributed or concentrated in a particular part of the country. A year ago, when the estimates by us and by the General Accounting Office were less than they are today, our estimates were that half of our problem was in the State of Texas. As the estimates have increased, the disproportionate amount of the increase on the cost estimate is in Texas, so that our cost estimate now says that about 60 percent of our problem is in the State of Texas. But the Southwest, California, Florida, and Illinois have been the areas of the country where there have been concentrations of one kind or another.

Mr. GIBBONS. Now, I know something about Florida. How did those ones in Florida get in trouble?

Mr. WALL. The list of items that I gave you—

Mr. GIBBONS. Take the Largo Federal Savings & Loan Association, it is in probably one of the wealthiest areas of the United States; it is fast growing. What did they do with their money?

Mr. WALL. On an institution-by-institution basis, I cannot respond, but I would be happy to for the record.

[The following was subsequently received:]

The principal problems addressed in the December 27, 1985 examination report were the following: Operating losses were primarily the result of the institution's low to negative net interest margin, caused by a low level of earning assets and a high cost of money. Non-operating losses were the result of setting up valuation reserves on loans and real estate owned and, until September 1987, the amortization of deferred loan losses. The loan losses have been caused by loan quality problems arising from large commercial real estate originations and participations purchased and from single-family purchases and service losses. Lax underwriting practices were the major contributing factor for the high level of substandard assets. Many of these participations reflect lax underwriting and appraisal practices.

Mr. GIBBONS. Well, I would like to know. You know, I do not see any indictments, I do not know anything else, I just wonder. I see that you have taken them over. Largo is a good, healthy area. There is no oil around. I do not know where they spent their money or where they threw it away, but—

Mr. WALL. I cannot speak to the one institution, but institutions in other parts of the country other than the Southwest, typically their problem assets are in the Southwest.

An institution, McLean Savings, here in the suburbs, was largely a Texas institution, and it happened to be located in the suburbs of Virginia.

Mr. GIBBONS. One of the oldest savings and loans in my area was First Federal Savings & Loan Association of Tampa, and it converted to something called Freedom Savings. I notice that it has a huge deficit. It was well run up until a few years ago, and I do not see anything happening at all to try to make up for those huge losses. Do you know where they threw their money away?

Mr. WALL. Again, I do not—

Mr. GIBBONS. I come from one of the more prosperous areas of the United States and I am just anxious to find out how they got into this.

Mr. WALL. Obviously, I am at a risk in trying to make a generalization, but I would say that we can be fairly certain that a good deal of their activity was in what they perceived to be the fail-safe market in Texas, Oklahoma, Louisiana, and to some extent an overheated economy in Florida itself.

Mr. MARTIN. One of the things you have in Florida is a high deposit area because of the large number of retirement people. The money in Florida is far more than is needed for their own expansion, so consequently they went out of their own trading area and invested in the Southwest.

Mr. GIBBONS. Well, they did not know what they were doing. What did you all do about that?

Mr. MARTIN. Well, I was not around then and—

Mr. GIBBONS. Well, did you replace any of the officers or directors or did you bring any kind of action against them?

Mr. WALL. I think in the case of Freedom, there have been over time at least three different sets of management in place.

Mr. GIBBONS. Well, you all approve all of them.

Mr. WALL. No, no—well, there were—

Mr. GIBBONS. How did they get in control? The FSLIC approved all the managers down there. You do not let the institutions operate—

Mr. WALL. Management approval per se was not a requirement in the early days. A board could hire a new president without the approval of the insurer. That is no longer the case, but that was the case in those early days.

Mr. GIBBONS. Let me ask you, are you all still guaranteeing new institutions in Florida?

Mr. WALL. You made reference to that earlier and I cannot recall that we have provided for insurance of accounts of a new institution in Florida, much less anywhere else in the country. It has not been an area of expansion.

Mr. GIBBONS. Do you have a policy that imposes a moratorium on new institutions until we get the old ones straightened out?

Mr. WALL. There have been moratorias on a State-by-State basis, where there have been problems with too liberal State charters.

Mr. GIBBONS. Is there one on Florida now?

Mr. WALL. There is not explicitly a moratorium, but there has not been interest in expanding that area.

Mr. GIBBONS. So, while you still have institutions collapsing all around, you are still guaranteeing new ones?

Mr. WALL. Well, no one is asking to, Congressman.

Mr. GIBBONS. How about you, Mr. Seidman, are you still—

Mr. SEIDMAN. We do not charter—

Mr. GIBBONS. You do not charter, but you guarantee. Nobody is going to open up without your—

Mr. SEIDMAN. We insure them after they are chartered, but we—

Mr. GIBBONS. I understand. I understand the difference.

Mr. SEIDMAN [continuing]. Under the present law, we must insure them if they are chartered by the Comptroller or in the Federal Reserve—

Mr. GIBBONS. Well, is the Comptroller still granting new charters in Florida?

Mr. SEIDMAN. He is granting very few. He has granted a few, but very few. When the States charter them, then we look at them to see whether they are viable or whether they are—

Mr. GIBBONS. The States are not going to charter them nor is the Comptroller going to charter them if you do not give them FDIC insurance. Now, I know that for a fact.

Mr. SEIDMAN. That is—

Mr. GIBBONS. They have never opened up; the State has never opened up one and—so you are ultimately the charterer, because you are the one who—

Mr. SEIDMAN. Yes, sir, but we do not have the power to refuse the Comptroller. If he charters it, we must give it—

Mr. GIBBONS. Oh, do not kid me. Listen, I have been involved in this business before. I am not a neophyte. If you give FDIC insur-

ance, the Comptroller will go along and so will the State. You are the ultimate charterer, and you know that is true.

Mr. SEIDMAN. We have asked for that—

Mr. GIBBONS. Well, you know it is true.

Mr. SEIDMAN [continuing]. In the new—the President is recommending that in the new law, but that is not the law today.

Mr. GIBBONS. Mr. Seidman, can you point out to me any bank that has ever opened in the last 15 years that did not have your insurance, whether State-chartered or Federal-chartered?

Mr. SEIDMAN. Yes, sir, there have been some banks, but the reason they have insurance is the law requires us to insure them if the Comptroller charters them, so we are not the ones that are—

Mr. GIBBONS. That is an old shell game.

Mr. SEIDMAN. We are on the wrong—

Mr. GIBBONS. I have been around for a little while. You do not get bank charters unless you, Mr. Seidman—the FDIC—insures them. You do not.

Mr. SEIDMAN. It works the other way. I respectfully submit that when the charter is issued by the Comptroller, we must under the law give them insurance.

Mr. GIBBONS. Yes, but you know that is not the way it operates in practice. If you will give them insurance, they are going to give them a charter.

Mr. SEIDMAN. I respectfully disagree.

Mr. GIBBONS. I have been involved in it, Mr. Seidman. I have been involved in it. I have been through the harassment that you all give and I think it is a good idea. I can remember when—you know, you could walk into a bank and I could tell whether your auditors were there or not; everybody looks half scared to death because they were so scared of the FDIC auditors.

Mr. SEIDMAN. Well, that is not all bad.

Mr. GIBBONS. That is a damn good thing. Well, apparently none of them were scared of FSLIC auditors, as that seems to have been a circus for the last 10 years. [Laughter.]

Mr. WALL. Well, I think it has changed in the last 2 or 3 years, but you are right, in the early eighties that appears not to have been the case.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Seidman, under the law we are told that you have the authority to move FSLIC out and move your people in and you have now taken over effective control of the insolvent S&L's. I am interested in asking you what action have you taken, since the President has offered his plan and announced this new procedure. What action have you taken?

Mr. SEIDMAN. We signed an agreement with the Bank Board to manage conservatorships which they created of insolvent institutions. Since that time, we have put that agreement into effect. We, along with the Federal Reserve, the Comptroller and the Bank Board supervisors, have been going into each of those institutions as they are put into conservatorship and taken control of them for the purpose of controlling their operations.

Mr. PICKLE. Then at that point, let me ask you, have you sent a representative now into these 300 different insolvent S&L's so that you can watch them or control them, as you said?

Mr. SEIDMAN. We are doing that as rapidly as the institutions are turned over—

Mr. PICKLE. Well, I wanted—

Mr. SEIDMAN [continuing]. And we are up to about 35 now.

Mr. PICKLE. Mr. Seidman, I am trying to find out how much have you done. How many have you put into conservatorship?

Mr. SEIDMAN. About 35 institutions.

Mr. PICKLE. All right. Now, you have got 35 and you have 265 yet to go. Obviously, you cannot send that many people out of your offices, where you have a manpower shortage now. What do you intend to do about that?

Mr. SEIDMAN. Well, we are sending people in, along with the other institutions, for the purpose of a review of those institutions which on the average will take 30 to 60 days. After that, we will leave just a very small group in the institutions and the rest will return to their regular duties.

Mr. PICKLE. You have sent FDIC employees into some 30 to 35 insolvents, is that your figure?

Mr. SEIDMAN. Sir?

Mr. PICKLE. Is that your figure, 35 now?

Mr. SEIDMAN. We have done about 35, yes, that is correct, sir.

Mr. PICKLE. All right. Now, the question then is whether that is enough, and I do not know that it is. If I look at the advertisement in newspapers in my part of the country, in Texas, the FDIC is advertising sales of home after home after home and commercial properties. You are literally dumping homes on the market. I do not know whether you would agree to that, but in effect you are.

The FSLIC has, through the Southwest plan, whether you like it or not, at least restored some confidence and the dumping has slowed down. Are you going to dump property on the market now through FDIC?

Mr. SEIDMAN. We propose to follow the same plan that we have used in the past, which is to get an appraisal of a home at current value. We usually get two appraisals. If someone makes us an offer at the appraised value, we sell it. If they do not, we do not sell it, so we sell at current value, but we do not speculate in the price of homes.

Mr. PICKLE. All right. Now, that is basically what the FDIC normally does with banks, they take their first loss and write it off and go on. You are in effect saying to me that is what you plan to do on these FSLIC's, the insolvents, is that correct?

Mr. SEIDMAN. I am saying to you that we are going to sell the homes to people who will pay us the appraised value.

Mr. PICKLE. We cannot settle that question today, but I think that one statement of yours is going to send out tremors throughout all of the United States. At least in the Southwest we have held the line. If you indicate that we are going to sell these properties, I think that is going to shock the market. I hope it does not have that effect, but at least you have stated that is your intent and that is what I wanted to ask you. Now, I want to ask—

Mr. SEIDMAN. May I reply?

Mr. PICKLE. Yes.

Mr. SEIDMAN. There is considerable argument about what depresses the market more. Should you sit with billions of dollars of properties and say as soon as the price goes up I am going to sell them, or should you try to get them back into the private sector at the current levels and therefore move the whole inventory into the private sector faster? I do not know anybody that can say for sure what the bottom line is, but it is clear that if you hold a large inventory off the market and tell people you are waiting until prices go up, it has a depressing effect on the prices. I think you can have both sides of that.

Mr. PICKLE. Perhaps so, and I think we can argue that at length. The FSLIC has said that is a good approach and we will try within, say, 10 years to make some sense out of all of this and hope that the prices will go up. But if you dump it I think that is going to be a frightful development in my part of the country.

Mr. Wall, you said that you have put together some 87 institutions in my State. I do not know that I fault you so much for your action in December. The law was changed and the tax benefits reduced, so by the end of the year you moved as quickly as you did, but the problem is you did not move soon enough. You took 18, 19 months on a problem we should have done in half that time, but, no matter, I think the FSLIC probably has handled through the Southwest plan the situation about as well as we could have expected.

But what bothers me—and I see that my time has run out—what bothers me is that you fault my State S&L's for coming on the market and the Federal S&L's have come on the market and come into creation just as much, and I do not think it does any good to point to this State or the other. There has not been proper oversight of these institutions, Mr. Gibbons is correct. We the Congress are at fault, because we have not demanded it. We did not know what was going on. There is no oversight.

Now, the administration has recommended that we put into force this new REFCORP. It is another off-budget agency. Do you think we are going to raise \$50 billion to give to another off-budget agency like Fannie Mae or Ginnie Mae? We do not know what they are doing. We have no idea whether they are solvent. We do not worry about it, because like the FSLIC, we say the Federal Government is going to bail that out, we do not have to worry about it, and the American people accept that.

Now, the administration has asked us to create another agency. I guess I am like the rest, I do not know whether we should do that or if we should try to fund it on budget. If your tax incentives only cost us \$5 to \$7 billion in December, that may not be a bad way to go about it. But the net of it is that I am saying to you that we do not have oversight. The FDIC, the FSLIC, and the Congress are all at fault. We get no recommendation from these agencies that you had better take action. We are all at fault.

Chairman ROSTENKOWSKI. Mr. Vander Jagt.

Mr. VANDER JAGT. Thank you, Mr. Chairman.

Thanks to all of our witnesses for their testimony.

Mr. Wall and Mr. Seidman, your shops have to be about the busiest in town right now, a beehive of activity. We thank you for taking time out and sharing with us your experience.

Mr. Seidman, in your formal statement, you were gracious enough to thank and compliment this committee for the tax incentives that were provided in last year's bill to FDIC assisted transactions that FSLIC had enjoyed for many years. Can you tell us how the FDIC is using these tax benefits to maximize the total savings to the Federal Government?

Mr. SEIDMAN. Thank you, Congressman Vander Jagt.

Yes, we are, of course, first trying to inform buyers on what the tax benefits are. As a matter of fact, we have a seminar today in Atlanta where we have invited buyers to inform them what tax benefits are available now. And, to inform them that when they bid on our institutions, they will be asked to tell us how they value those tax benefits.

We have trained a special group of people on our staff in the benefits that are available. As they deal with buyers at the particular sites they will be able to provide that information. Our effort is to get the tax benefits, to get the value of them that is being used by the individuals and use that to evaluate the overall transaction and deciding how the sale of an institution should be made.

Mr. VANDER JAGT. Our first witness this morning took kind of a dim view of the tax benefits route, although he did acknowledge that in some specific transactions it was a very useful tool to maximize the total Federal savings to the Government, and I think acknowledged that the flexibility of having this was very important.

How important is it, in your view, that these tax rules be extended beyond the expiration date of this year, and, if they are extended, would you recommend any modification?

Mr. SEIDMAN. We believe that it will make it much easier for us or whoever is dealing with these institutions to make deals with buyers if these tax benefits are available. We believe, therefore, it will lower the amount of funding that we will have to provide. The resulting tax benefits will come in over a number of years, so that the up-front costs will be less. Therefore, we will have to pay out less up-front and over the years the buyers will get the tax benefits back, so we think it makes an easier transaction.

It is vitally important that the law be clear, so that the buyer knows exactly what he is getting and then he can make a sound bid in competition with others. We think it is important that the same rules apply both to the thrifts and to banks, which was accomplished thanks to the committee's efforts in the prior year. We think it is important to us in affecting transactions to continue those benefits.

With respect to S&L's, under the President's plan, to the extent that those benefits are not there, there will need to be more money paid out, and the Treasury is on the hook for it directly. So, with respect to the S&L transactions in the future, if the President's plan is put in place, the cost will come up front right away, because the amount that will be paid by the buyer will be less. Therefore, Treasury has to make up that difference, so you are going to get it immediately and probably in a more costly way.

Mr. VANDER JAGT. You referred to the importance of the clarity of the law in putting these deals together. It is my understanding that in FSLIC transactions, where an unhealthy thrift institution is acquired by a healthy nonfinancial business, that the built-in losses are now able to be deducted from the profits of the healthy nonfinancial business. Does FDIC have that same weapon in their arsenal?

Mr. SEIDMAN. Those are transactions where there are guaranteed capital values, as in the Pearlman case or the Bass case, as I understand it. We have not done transactions like that.

Mr. VANDER JAGT. Why?

Mr. SEIDMAN. Well, we have never thought that that style of transaction was the most cost efficient way of handling the situation and, of course, we did not have the tax benefits up until a few months ago. Therefore, that form of transaction was not available to us. We have preferred to sell the institution on a net loss basis and not have a continuing guarantee of assets over 8 or 10 years. As Mr. Bowsher said, it takes a tremendous amount of effort to administer those types of contracts. We have had some experience with that in earlier years and so we have tried to stay away from those kinds of contracts.

Mr. VANDER JAGT. Thank you very much.

Mr. WALL. I wonder if I might make a couple of points. As the chairman has indicated, the tax benefits were not available as a resource to use.

Moreover, FDIC is, much more limited as to who may buy a bank. Under the law, if you own a bank, you are a bank holding company and you are prevented or prohibited from doing a number of other things. Consequently, there is a limited list of potential purchasers who may want to do business with a FDIC-insured bank, as compared with the FSLIC which has virtually no limits on who may own a thrift.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you very much, Mr. Chairman, and thank you, gentlemen, for your testimony.

I would like to return to a line of questioning that I pursued with Mr. Bowsher earlier about the insurance of \$100,000 provided for depositors in banks and savings and loans. In the practice of some well-off people investing multiples of \$100,000 in a number of institutions, and even beyond that, the practice of some brokers in arranging for brokered accounts in many, many institutions on behalf of the same depositor, can you tell me or give me any idea at all, from the point of view of the banks and of the savings and loans, separately, the degree to which the multiple coverage in particularly the brokered multiple coverage has contributed to the problem that we are in now?

Mr. SEIDMAN. It is certainly clear that where brokered deposits have been the source of very rapid growth in institutions, that that has contributed to the problem. Rapid growth has often been accompanied by very unwise use of the funds. I think that the key area for concern is whether brokered deposits are being properly used or not.

We are proposing a regulation very shortly which will monitor the use of brokered funds by our institutions and require, if they

are going to increase by any material amount, to get approval of their plans in advance. Therefore, they will not be able to grow using brokered deposits.

In the past, we have monitored brokered funds and as a result we found out afterwards. We are now changing the ruling so that they will have to inform us. In that way we think we can control the misuse of brokered deposits.

Mr. WALL. From the FSLIC side, I think we would make a similar kind of response in terms of where brokered funds were permitting or were part of a rapid growth. They can be identified, at least, as tangentially related to an institution that was out of control.

On the other hand, there was a time and a place for brokered funds to be utilized when we did not have sufficient resources and needed to buy time to explicitly direct brokered funds into institutions that were in our control or within our supervisory limitation.

Additionally, we are taking an additional step as far as controlling brokered funds by our risk-based capital approach. In the risk-based capital, you have to provide for capital on the basis of the size of your institution and on the basis of the risks involved.

So, in looking forward, we expect riskier institutions to shrink in size because they will have to bring their level of risk into line with the capital that they have or can get into their institution. This will prevent them from being able to use the brokered funds.

Mr. PEASE. I know this is difficult, but let us say, for example, that we have got about an \$80 billion problem with the S&L's. Do you have any notion at all of what that figure would be if there had not been brokered deposits in the last 3 or 4 or 5 years?

Mr. WALL. Congressman, I do not know how it is possible to take one of the elements out of the list of eight elements that I identified earlier—and say that one caused this much and this one caused this much of the problem.

I know there are economists all over the country who are trying to make those kinds of judgments and guesses, and I think the latter word is probably the most appropriate.

Clearly, they have been in some cases a problem and they I think have been recognized as such by the regulatory structure and by the supervisory forces that are in place, both for banks and thrifts, and we are dealing with them. As I indicated, the risk-based capital construction, is going to be much more demanding of capital as to the size of your institution in a very important way.

Mr. WHITE. Congressman, let me add to what Dan Wall has said. If there had not been brokered deposits, you would have found the same thrifts opening up their own money desks. They would have taken out bigger ads in the Wall Street Journal and in other major newspapers, trying to attract deposits. There are lots of alternative ways, slightly more costly, but only slightly more costly, for a savings and loan that wants to try to attract funds to do so.

Mr. PEASE. But they could not have done that, had multiple accounts and not been subject to the \$100,000 insurance.

Mr. WHITE. That is a separate issue from the brokered deposits. The brokered deposit issue is more narrowly focused. That is why I think that the proper focus should be on where and how the thrift invests its funds, not where and how the thrift gets its funds.

Damage is done by poor investments by thrifts. That is where virtually all of the regulatory effort at supervision and at examination, should be focused.

Mr. PEASE. Thank you.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman. Welcome, gentlemen.

Mr. Seidman, under the February 6 proposal that President Bush has recommended to solve the savings and loan crisis, not merely bail them out. What happens to a savings and loan that was attempting, through the regular order of business, to purchase other savings and loans at the time of the announcement of President Bush's proposal. These purchasers had done all that they were asked to do, only to run into a new change of direction by the Federal Government edict handed down through the bureaucracy only to find that February 6 stopped everything and they had to apply to different places? Am I correct in understanding that a savings and loan now would not go to FSLIC, but they would go to FDIC if they wanted to buy outstanding institutions?

Mr. SEIDMAN. If they are trying to buy one of the institutions that has been turned over to the FDIC under the conservatorships, then they would have to come to the FDIC to make a transaction, if they want a Government-assisted transaction. Of course, if they want to buy without Government assistance, then they—

Mr. ANTHONY. Well, nobody wants to do that.

Mr. SEIDMAN. Nobody wants to do that.

Mr. ANTHONY. Well, the Government assistance is not worth anything, but it is worth something, because everybody wants it.

Mr. SEIDMAN. The answer to the question is that they want assistance, and if they do and it is one of the institutions turned over under this contract, then they have to come to the FDIC.

Mr. ANTHONY. Were all of them turned over under the contract?

Mr. SEIDMAN. Well, they are being turned over. The ones that were not dealt with by the Bank Board and FSLIC are now being put into conservatorship and turned over to the FDIC. We have received about 35 out of an estimated 220 or so that will be turned over.

Mr. ANTHONY. I have an unusual circumstance—and Mr. Wall is very familiar with this and has been generous with his time in briefing me and allowing my constituents to come in and visit with him and get a complete briefing on it—but it appears to me that when you have a change of rules and a change of rules that are reacting to public pressure and congressional pressure, that you always have somebody that gets pushed off the cliff.

I have a small S&L in my hometown that has expended over \$100,000 in complying with all the rules and all the regulations, only to be caught up in this last-minute change. And I guess my question is can you establish something within the order of resolving the disposing of these S&L's, people who are already into the system, who have already expended a great deal of money, time and effort, to see to it that they do not walk away with a very bad taste in their mouth in terms of how they were treated during this?

Mr. SEIDMAN. We have indicated to all institutions in that situation that we will meet with them promptly. We will review what-

ever proposals they have, but most of those proposals involve income maintenance, notes and other kinds of things which, under this plan, we are not authorized to issue. We will handle those institutions when Congress acts and provides us with the funding to do transactions with them. That is why I concluded my statement by saying that until the Congress acts, those are, unfortunately going to be on hold.

Mr. ANTHONY. Well, you anticipated my third, fourth, and fifth questions.

Mr. SEIDMAN. Thank you.

Mr. ANTHONY. So, basically, all I can say to this board of directors is that, although you have done everything that you have been asked to do, until this proposal that has been presented to the Congress and is accepted, they are just put on hold, they are in a black hole some place trying to wait and see what will occur.

Mr. SEIDMAN. They can come in and discuss with us their transaction. We will make an agreement with them, if we believe it is the appropriate agreement, contingent on Congress acting.

Mr. ANTHONY. Right. This leads me back to my controversy with Mr. Wall and also Mr. White. Explain to me, if you can, why it is proper to use the Tax Code only for one particular State, to the exclusion of an adjoining State that is in keen competition. You have got 6 percent of the problem in a great big State like Texas and a little bitty State like Arkansas can just wait its turn, and then you come back and ask somebody from Arkansas to vote for this proposal and vote for it in a hurry, when I personally think we have been treated rather shabbily. So, I am just curious how the regulators explain why some S&L's are entitled to the tax benefit, to the exclusion of a neighbor right across a State line, and who made the decision?

Mr. WALL. A couple of responses. First, we did provide assisted transactions in your State, as well as all the States around it. Any FSLIC assistance is a tax benefit because it is not taxed as income, whereas, effective January 1, 1990, it will be taxed as income.

Mr. ANTHONY. A tax benefit, I assume, would be some type of a tax expenditure, which some people could call a subsidy?

Mr. WALL. Well, any kind of FSLIC assistance brings with it a tax benefit, so any action we have taken in your State and in other States, there are tax benefits inherent in it.

We had under way in the State of Arkansas three packages that had bids on them and for which we were negotiating, one of them involving constituents of yours. Had the proposal not been forthcoming from the President when it was, we probably would have concluded those transactions by now. So, you are right, they have been interrupted by a change of policy and a change in course of events, and that is most unfortunate. I have told you that privately and I tell you that publicly.

But in terms of providing assistance on a discretionary basis, we provided the assistance where we found acquirers willing to step to in line and within a timeframe in which it made sense for us to proceed. Again, any FSLIC assistance is tax a benefit, because they come without a taxable impact.

Chairman ROSTENKOWSKI. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

Mr. Wall, Mr. White, one of you who gave us this handout called "Simplified Thrift Accounting",—

Mr. WALL. Mr. White.

Mr. SHAW. Mr. White, you are up at bat, then. In your example C, you show that the thrift starts to get into trouble when the amount of the deposits exceed the amount of the loans. Several questions with regard to that: How was the value of the loans done? Are they discounted and are you looking at the equities and the properties, the values of the properties that are the subject of the loans or the security for the loans? How do you come to evaluate the loans?

Mr. WHITE. That is an excellent question, Congressman. We operate off a set of accounting principles. It is an historical cost based accounting system. For example, one of those principles is that when a loan is foreclosed and the property is taken into the thrift's own portfolio, real estate owned, REO, the thrift is required to have an appraisal of the property; almost always that property is going to be worth less than the loan that was originally made on the properties. That is one of the important sources of the decrease in value of the assets of these thrifts.

In other instances, it was direct investments that a thrift made in real estate that turned out to be less than the original investment. In others, the borrower can only pay back a certain fraction of the loan or at a reduced interest rate, all of which means that the asset is going to be worth less than the original value.

Mr. SHAW. So, a loan that is not necessarily in default but may be into a workout situation, is that devalued?

Mr. WHITE. You are now getting me into principles of accounting that go beyond my limited knowledge of accounting. I am not an accountant, I am an economist. But under some circumstances, the loan would be written down in value because the reduced interest payment or the delayed return of principal would make that loan worth less in present value terms.

Mr. SHAW. Now, when you are also evaluating these thrifts, these thrifts owned things other than loans; they have buildings and machinery and equipment—

Mr. WHITE. Right.

Mr. SHAW. They have all types of assets. Of course, those would have to be evaluated and put into this formula also in determining the net worth, is that not correct?

Mr. WHITE. That is correct.

Mr. SHAW. Would you, for those purposes, use the historical cost, or would you use an appraised value?

Mr. WHITE. Well, I believe that there is a requirement that they get new appraisals when there is a reason to believe that the value of these assets have gone down. As we have discovered to our sorrow, however, those appraisals have not happened frequently enough, and they have not been accurate enough. When we have to dispose of a savings and loan, either by liquidating it or by finding an acquirer, our costs inevitably turn out to be much larger than that which the asset and liability picture of the thrift—

Mr. SHAW. Well, if you are in the position of using historical cost, less the accumulated depreciation, you may very well find, particularly in my State of Florida, a situation where the appraised

value would actually come out much higher than what you would evaluate the real property and building at, using historical cost less accumulated depreciation.

Mr. WHITE. Well, now you are getting into an area that I am very sympathetic to. The accounting profession is too much wedded to historical cost and does not focus enough on current value, either up or down. You have just indicated an instance where the thrift is penalized because assets that are worth more today are not being properly reflected on the balance sheet. On the other side, all too often assets that are worth less today are not being properly reflected.

Mr. SHAW. Mr. Wall, let me get into one other area. You made the statement a while ago as to "it is not if Texas is going to come back, it is when Texas is going to come back." Has thought been given to the proposition that maybe what the Federal Government should be doing, rather than handing out all of these nice tax breaks and handing out certain guarantees on capital, guarantees on assets, and more of the same with regard to guarantees on deposits, is setting up Government-owned holding companies to put some of these thrifts into or combine them into, with new management, while waiting for Texas to come back, and then putting the thrifts back into the mainstream of the privately held thrifts and doing some type of offering itself? Obviously, the people who are buying these deals are not only getting the tax breaks, which is costing the taxpayers more money in the long run, but they do it with the motives of reaping profits out of what they buy?

Mr. WALL. You have put several elements together in a very good question, and let me try to respond to it, if I might, a piece at a time. The last point, based on our estimates, we do not believe might cost the taxpayers more overtime.

Then, with regard to the question of putting together the holding company, in a sense that is what we are doing with our Southwest plan package. We are consolidating multiple institutions into one, bringing in new management, and bringing in private capital. In the State of Texas alone, \$1.1 billion of new capital has come into the industry. New capital will only come if the people who are investing it have confidence or are bringing new capital in with the new management. So, in a very real sense, we are bringing in new capital on the private and public side.

We took several institutions in Texas and combined them together with a very large and very well-known insolvent institution in the Sun Belt. That institution has several billion dollars in deposits that are backed by brokered funds. That is not what caused the problem, but that "hot" money is there and we see the need to shrink the size of that institution by 50 percent, and then, in the normal course of events, we would have sold that institution.

So, on the private side we are doing just as you indicated, putting private managers who bring in their own capital in charge of those assets. And, let me say that much has been said about full coverage. Maybe on the average, you could say we were approaching 50 percent of the institutions having coverage in one way or another, but not full coverage. So, there is half of that institution that now has the coverage of new capital and new management. These institutions have to run profitably in order to get the tax benefits. So,

half of the institution is ours and we have that responsibility. We have it, whether we own it explicitly or whether we own it by contract partnership with the private sector. We also have ownership in an institution on the public side in the name of Sun Belt. We have four such situations in the State of Oklahoma. So, yes, we are doing it in ways that we deem appropriate and we have been able to get people to the table or as we have foreseen being able to get people to the table over time.

Chairman ROSTENKOWSKI. Mr. Moody will inquire.

Mr. MOODY. Thank you, Mr. Chairman.

Mr. Wall, you were listening intently while we were discussing with Mr. Bowsher the GAO's testimony and you remember the series of fairly serious reservations he had about what he called the December deals: thinly capitalized institutions, the cost advantage over healthy S&L's, the lack of incentive to manage assets, and so forth.

I do not know how much you want to comment now—maybe you would rather do it in a letter—but I would appreciate your reaction to some of the fairly substantial criticism. Could you take a moment at least to single out one issue—the cost advantage over healthy S&L's. The fact is that since they are competing for the same money, they have a cost advantage, over healthy S&L's and maybe they are pushing them toward the brink. You do not agree with this analysis?

Mr. WALL. No. You want me to speak to that one specifically or—

Mr. MOODY. Just limit it to that one for a second.

Mr. WALL. Then let me ask Larry White to speak to that one.

Mr. MOODY. OK. Thank you.

Mr. WHITE. I am sorry, I was distracted—competing with the—

Mr. MOODY. I was asking about the so-called cost advantage over healthy S&L's.

Mr. WHITE. I think that is a total misperception of what is going on here, Congressman. These thrifts are basically managing a group of assets on our behalf, and we are providing yield maintenance while they are managing those assets. The other assets are at risk, and when you look at their capital in comparison to the assets that they have at risk, they are really quite well capitalized. The other savings and loans around the corner are probably less well capitalized. If anything, it is the newly established thrift that is operating at a disadvantage compared with the thrift around the corner, because it is better capitalized and the thrift around the corner is typically less well capitalized.

Mr. MOODY. All right. Well, I think—

Mr. WHITE. Excuse me. In any event, the thrift around the corner is in much better shape competing with the new guy than they were with the insolvent that preceded him. Previously, the disadvantage was truly great, because the insolvent was going to be bidding up interest rates, was going to be making loans possibly at a disadvantage—

Mr. MOODY. Right.

Mr. WHITE. Just as a way of staying in business.

Mr. MOODY. I think maybe it wasn't a question of capitalization so much as the question of differential tax treatment. Maybe you can straighten this out in the written comments.

Mr. WHITE. Again, I think the same arguments would hold.

Mr. MOODY. Mr. Martin?

Mr. MARTIN. Congressman, there is something else that I think is very important as far as this level playing field. Let us use in the State of Texas, where in effect we took 87 savings and loan institutions in Texas and reduced it to 17. In other words, we wiped out 70 in the process. I know that term is pretty bad, but they were eliminated, but at the same time they went from 869 branches down to 602 branches, so for the healthy institutions they have obviously less competition, plus the fact that these institutions are shrinking their deposit base almost 20 percent. So, I think maybe the healthy institutions are better off as a result of this.

Mr. MOODY. All right. Thank you. Any follow-up written statement would be appreciated.

[The following was subsequently received:]

Under other provisions incorporated in some of FSLIC's assistance agreements, the amount of FSLIC yield maintenance declines over time. This provides an incentive to dispose of assets and reinvest the proceeds of sale when the level of FSLIC support is less than the asset manager could obtain through such alternate investments.

Regarding your first specific question, the Bank Board has not committed the Federal Government to spending "far more than \$100,000 on each deposit." Further, the cost of a FSLIC insurance action is not limited to the cost of settling the insurance claims of depositors. FSLIC incurs additional operating and legal expenses when the institution is placed in receivership. Only years later does the government receive some reduced amount of offsetting returns as the assets of the failed institution are liquidated.

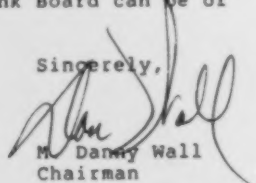
The statutory limits on FSLIC assistance are not framed in terms of the insurance payments that would be made if the institution were liquidated. Rather, the statutory limits are based on the cost of liquidating an institution as part of an insurance action. With limited exceptions, § 406(f) of the National Housing Act states that FSLIC assistance to a thrift may not exceed that "which the Corporation [FSLIC] determines to be reasonably necessary to save the cost of liquidating (including paying the insured accounts of) such insured institution..."

As the enclosed table shows, in every FSLIC assisted acquisition in 1988, FSLIC's cost of assistance was less than its estimated cost of liquidation. Even taking into account the tax revenues foregone as a consequence of tax benefits (which the law does not require FSLIC to consider), the cost of assistance was greater than the cost of liquidation in only 6 of 85 transactions. For the remaining 6 transactions, the comparative cost differences between assistance and liquidation were small in both absolute and percentage terms.

Your second question asks about the sensitivity of future interest rates to the Administration's proposal to raise \$50 billion in bonds. Without question, interest rate assumptions can be sensitive to large amounts of supply of agency securities in that maturity sector. The Bank Board, however, was not involved in the preparation of the cost estimates that underlie the Administration's proposal. A more informed response to this question could therefore be provided by the Treasury Department or the Office of Management and Budget.

I appreciate the importance of the questions you have raised. Please let me know if the Bank Board can be of further assistance to you.

Sincerely,



M. Danny Wall
Chairman

ESTIMATED TAX BENEFITS
Cases Processed From 1/1/88 to 12/31/88
(in millions)

CASE #	ACQUIRER	1 NET PV OF COST OF SOLUTION	2 ADJUSTED NPV OF COST OF SOLUTION	3 AGGREGATE TAX BENEFITS OF ASSET PRIS.	4 IMPUTED COST OF SOLUTION	5 ESTIMATED COST OF LIMITATION	6 NET SAVINGS OF SOLUTION
C-122	Home TELA	13.1	13.8	0.9	13.9	13.8	(0.1)
C-123	Atlantic Financial	81.5	81.5	12.6	81.5	107.1	25.6
C-124	Grant West SB	3.3	3.3	0.0	3.3	5.9	2.6
C-125	Stearns FSB	164.1	153.2	23.5	176.8	207.1	30.3
C-126	Sterling SA	15.8	15.2	1.9	17.2	28.8	3.6
C-127	United FSB	5.5	6.5	0.0	6.5	9.6	3.1
C-128	Home FSLA	7.1	7.1	0.3	7.4	16.0	10.6
C-129	Barlton Valley SLA	72.1	72.1	8.4	80.5	105.3	24.8
C-130	EuroSA	303.5	283.5	44.8	308.3	395.9	87.6
C-131	First SA	9.5	9.3	0.0	10.8	16.3	6.5
C-132	Security First	9.4	9.3	0.0	10.8	12.6	2.6
C-133	Monkman FSLA	4.0	5.1	0.2	4.8	17.5	13.5
C-134	Florida FSLA	9.3	9.3	1.0	10.3	15.1	2.8
C-135	Florida SLA	4.0	4.7	1.9	6.7	16.9	6.2
SA-001	Coastal Banc	145.1	135.0	4.1	141.1	161.3	15.2
SA-002	Southwest SA	2,115.3	2,102.3	13.0	2,115.3	2,502.7	387.4
C-136	River Valley FSB	16.2	17.8	5.1	17.8	25.0	7.2
C-137	Rock Falls SB	17.8	17.8	0.0	17.8	26.9	9.1
C-138	First FSB	16.2	13.7	1.2	16.9	19.8	3.9
C-139	United Savings	2.7	2.7	0.0	2.7	6.7	4.0
C-140	Standard FSLA	16.7	16.6	0.1	16.7	48.1	31.4
C-141	First FB FSB	12.2	12.2	0.0	12.2	19.3	7.1
C-142	Metropolitan FSB	299.0	299.0	1.4	300.6	416.4	116.8
C-143	Washington Federal	2.4	2.4	0.0	2.4	5.9	3.5
C-144	Old Stone Bank	40.1	39.6	5.3	45.0	65.2	20.2
C-145	Security Trust FSLA	17.1	16.9	0.2	17.1	26.1	9.0
C-146	First FSB & Trust	(0.5)	(0.4)	0.1	(0.5)	12.9	13.4
C-147	BC Bancshares INC	24.4	24.3	0.4	24.8	32.5	7.7
C-149	United Savings	3.6	3.6	0.0	3.6	10.5	6.9
C-150	Secur FSB	13.0	12.9	0.1	13.0	15.3	2.3
C-151	Washington FSLA	29.3	23.3	4.0	29.3	45.2	15.9
C-152	Western FSLA	565.8	545.8	101.9	647.7	700.1	32.4
C-153	Home Federal SLA	5.0	5.0	0.0	5.0	10.3	5.3
C-154	Union FSB	35.0	34.7	2.7	37.4	44.9	7.5
C-155	Butterfield SLA	281.2	281.2	11.2	292.4	336.6	44.2
C-157	1st Federal Bank	8.1	8.1	1.7	9.8	16.1	6.3
C-158	American SB	5.7	5.7	0.0	5.7	10.1	4.4
C-159	Tracy SB	3.0	2.8	0.6	3.4	7.0	4.6
C-160	First FSB of Indiana	28.0	28.0	3.8	32.6	30.2	(2.4)
C-161	Republic SB	25.2	21.9	3.8	25.8	28.0	2.2
C-162	New Peoples FSB	34.9	34.1	1.8	35.9	70.0	34.1
C-163	Crossland Savings FS	11.8	11.8	0.0	11.8	25.1	13.3
C-164	1st Nationwide FSB	148.7	148.7	8.2	156.9	224.2	67.3
C-165	Flagship FSLA	23.8	23.8	0.0	23.8	29.3	5.5
C-166	Liberty FSB	10.3	10.2	0.3	10.6	14.7	4.1

ESTIMATED TAX BENEFITS
Cases Processed From 1/1/88 to 12/31/88
(in millions)

CASE #	ACQUIRER	1 NET PV OF SOLUTION	2 ADJUSTED NPV OF COST OF SOLUTION	3 AGGREGATE TAX BENEFIT OF ACQUISITION, PMTS.	4 IMPUTED COST OF SOLUTION	5 ESTIMATED COST OF LIQUIDATION	6 NET SAVINGS OF SOLUTION
SA-006	American Fed. Bank	1,313.8	946.1	348.0	1,314.9	1,510.8	203.9
SA-006	Herndon of Texas	649.3	555.9	131.2	647.1	722.1	35.0
SA-013	First Heights FSA	1,102.0	907.5	298.7	1,206.2	1,274.5	44.3
SA-015	Guaranty FSA	1,489.1	1,461.0	119.5	1,381.2	2,170.0	588.8
SA-016	Franklin Fed. Bancorp	999.5	956.1	43.4	999.5	1,043.0	43.5
SA-017	Mutiny S&LA	1,320.8	1,273.4	79.0	1,332.4	1,448.2	315.8
SA-018	Americity Fed. Savng.	160.0	155.7	5.1	160.0	158.3	(2.3)
C-367	Early Invest. Grp.	16.0	16.0	0.3	16.3	33.1	18.0
C-368	1st Western	2.0	2.0	0.0	2.0	0.7	6.7
C-369	Pacific First Bk.	167.5	145.0	37.9	182.9	241.6	58.7
C-370	First FSA	19.5	19.3	2.9	22.2	22.5	0.3
C-371	Golden West	98.7	89.6	12.2	101.0	110.1	8.3
C-372	First Westside	118.3	110.3	23.9	142.2	251.1	108.8
C-373	Citicorp Mtg	20.3	17.6	2.7	20.3	35.7	15.4
C-374	Byn Financial	66.4	63.0	11.0	74.7	142.5	67.0
C-375	HCC Financial	13.5	13.5	1.6	15.1	102.9	87.0
C-376	Equimark	146.8	137.7	11.3	148.9	281.8	52.9
C-377	Barnett Bank	4.9	4.3	0.6	4.9	30.8	25.9
C-378-9	Base Group	1,099.0	1,095.3	874.7	2,370.2	3,333.0	762.8
C-380	Citizens FSB	187.9	186.4	5.9	190.3	253.1	62.8
C-381	Jackson County	62.5	62.7	9.8	72.4	86.7	14.3
C-382	Community Holdings	54.8	54.7	5.4	60.1	79.3	19.2
C-383	First Nations FSA	1,086.5	1,086.5	648.9	2,333.4	2,430.7	97.3
C-384	Metropolitan FSA	59.4	59.4	13.2	72.6	75.5	2.7
C-385	Western FSA	11.4	10.3	1.3	11.4	22.9	11.5
C-386	Home Federal	241.3	233.0	31.2	264.0	320.6	31.4
C-387	South East Holding	97.0	86.0	18.0	99.0	221.5	205.5
C-388	Golden West	385.3	385.3	187.8	1,051.0	1,024.9	(26.1)
C-389	Coast to Coast	14.0	14.0	49.4	43.4	42.2	27.2
C-390	First Westport Bk	33.8	32.9	3.9	44.8	111.6	15.21
C-391	Cal Valley Bk	17.4	17.4	3.5	17.4	30.3	12.9
C-392	Cal Fed.	151.1	139.0	17.8	177.4	186.7	7.1
C-393	Richmond National	983.1	1,031.5	156.5	1,189.9	1,181.2	(6.7)
C-394	Home FSA	8.0	7.9	1.8	9.8	13.6	3.2
SA-020	CIBB Corp	1,846.3	1,775.4	298.7	2,074.1	2,117.0	42.9
SA-021	Utley Fed	5,464.4	6,913.3	1,546.0	6,477.3	6,422.3	345.0
SA-022	Pacific USA	566.2	562.0	64.9	626.9	642.2	23.3
SA-023	Contra Corp	376.5	328.0	109.1	437.9	443.7	25.8
SA-024	Local FSA	89.0	87.7	2.5	90.2	145.2	55.0
SA-025	Hyperion Prr., LP	1,372.2	1,365.2	31.3	1,396.3	1,492.0	95.7
SA-026	Northwest Federal	78.3	78.3	4.4	82.7	113.9	31.2
TOTAL		28,346.5	27,892.4	5,538.9	32,831.4	37,280.3	4,449.0

TEXAS MERGERS
Cases Processed From 1/01/88 to 12/31/88

SURVIVING ASSOCIATION	DISAPPEARING ASSOCIATION	LOCATION
First Savings Association Brenham, TX	Bluebonnet SA	Brenham, TX
Southwest Savings Association Dallas, TX	Lamar SA Briercroft SA City SLA Stockton SA	Austin, TX Dallas, TX San Angelo, TX Dallas, TX
Merabank of Texas, FSB El Paso, TX	First Financial Brownfield FSLA	El Paso, TX Brownfield, TX
American Federal Bank, FSB Dallas, TX	Gladewater FSLA Commerce FSLA Irving SA Majestic SA Richardson SLA Mercury SA of Texas Longview SLA Ben Milon SLA Paris SLA American Banc SA Southland SLA Skyline SLA	Gladewater, TX Commerce, TX Irving, TX McKinney, TX Dallas, TX Wichita Falls, TX Longview, TX Cameron, TX Paris, TX Dallas, TX Longview, TX Dallas, TX
Sunbelt Savings, FSB Dallas, TX	Federated SLA Multibanc SA Sunbelt SA of Texas Summit SA Texans SLA First City SA Western FSLA Independent American SA	Brady, TX Dallas, TX Dallas, TX Dallas, TX Texarkana, TX Irving, TX Dallas, TX Irving, TX
Merabank of Texas, FSB El Paso, TX	State FSLA of Lubbock	Lubbock, TX
First Heights FSA, a FSB Houston, TX	Bay City FSLA Gulf Coast SFLA Heights SA Allen Park	Bay City, TX Richmond, TX Houston, TX Houston, TX
First Heights FSA, a FSB Houston, TX	Champion	Houston, TX
Guaranty FSB Dallas, TX	First FSLA of Austin Delta FSLA of Texas	Austin, TX Alvin, TX

Franklin Federal Bancorp Austin, TX	Guaranty FSLA Dallas, TX	
	Great West SB Creditbanc SA Franklin SA	Austin, TX Austin, TX Austin, TX
Olney Savings & Loan Olney, TX	Olney SA Security FSLA First FSLA of Amarillo San Angelo SA Odessa SA Southwest SLA Banc Home SA Southern SLA Heart O' Texas SA Shamrock FSB Petroplex, -SA	Olney, TX Pampa, TX Amarillo, TX San Angelo, TX Odessa, TX Arlene, TX Midland, TX Brownwood, TX San Saba, TX Shamrock, TX Midland, TX
Americity Federal Savings Dallas, TX	Tesoro SLA	Laredo, TX
Consolidated FS&L Dallas, TX	Mineral Wells SLA Home SLA Mesquite SLA First Western SLA Commodore SA First Federal SLA Sentry Savings Vista Savings Interwest Savings Lamesa FSLA -- Southern Federal Banc Reliance Savings NorthPark SA Metropolis FSLA Hi-Plains SLA	Mineral Wells, TX Lufkin, TX Mesquite, TX Colorado City, TX Dallas, TX Big Spring, TX Slaton, TX Odessa, TX Fortworth, TX Lamesa, TX Lancaster, TX Houston, TX Richardson, TX Hurst, TX Hereford, TX
First Texas Bank FSB Houston, TX	Gibraltar Savings First Texas Savings Killeen SL Home Savings Montfort Savings	Houston, TX Dallas, TX Killeen, TX Houston, TX Dallas, TX
Pacific Southwest SB, FSB Corpus Christi, TX	First Federal SLA Yoakum FSLA Sequin SA Charter SLA Union SLA Independence SLA Keystone SLA Bayview FSLA	Luling, TX Yoakum, TX Sequin, TX Corpus Christi, TX Goliad, TX Gonzales, TX Lampasas, TX Corpus Christi, TX
Texas Trust SB, FSB Llano, TX	Peoples SLA Burnet SLA Lee SA Ranchers SA	Llano, TX Burnet, TX Giddings, TX Johnson City, TX
United Savings Assoc. of Houston Houston, TX	United SA of Houston	Houston, TX

Mr. WALL. I would call your attention and those in the audience, to the question regarding lack of incentives to manage assets. That is really our answer to question number 9 which is attached to our testimony.

Mr. MOODY. Thank you.

Mr. Seidman, do you treat the tax benefit question differently than FSLIC does? The reason I ask is that FSLIC seems to have a pretty clear idea at the time of what the "hit" is, if I can use the term "hit," meaning the cost to the public. It is my impression that with the FDIC we sometimes hear one number and then another number. Let me refer particularly to the case of American Bank Shares in Texas, where first we had a number something like \$300 million, and later it rose to \$2 billion. Do you want to comment on the differential treatment of tax benefits between FSLIC and FDIC? If my example is off-base, let me know.

Mr. SEIDMAN. I do not think that the particular case you cite, I do not recognize the numbers, but I—

Mr. MOODY. Is there a time gap between what we first hear and what later on it turns out to be?

Mr. SEIDMAN. In the first place, we have not had much experience with tax benefits. We only came into them in the last couple of months, so it would be hard to say that our experience is different from theirs, because we really have not had any. We are starting out to handle those, I would say, in a comparable way to the way the Bank Board has handled them. That is to estimate the amount of benefits, point those out to the buyer and then determine how much the buyer will pay for them. I do not know of any basic difference in approach.

Mr. MOODY. So, there is no time lag in your case, the whole story is up on the table at the time of the transaction?

Mr. SEIDMAN. We will, but at this time we cannot give you our actual experience because we only have been in it for a couple of months, and so it is very hard for us to know. In a couple more months I think we will have enough information to show you how much buyers are paying for them.

Mr. MOODY. And American Bank Shares is not a case you are familiar with, then?

Mr. SEIDMAN. I am not familiar with that insofar as the tax benefits are concerned, no.

Mr. MOODY. OK. Thank you very much, one more point. Mr. Wall and Mr. White could you please give me your comments on how sensitive the cost of the President's new proposal is to the interest rate assumptions. My hunch is it might be pretty darn sensitive, but any calculations you could provide me would be helpful.

Mr. SEIDMAN. The quick response is that, while there is an upside, there is also a down-side. That is the extent to which interest rates may go up, there may be a higher cost of anybody's estimate, ours, the FSLIC's, the President's, GAO's or anyone else who used interest rate assumptions to develop their estimates.

But what does not get any attention or very seldom gets attention is that if the economic scenario should turn to the positive side in terms of the more favorable interest rate scenario or market recoveries, such as Texas, California more significantly even, and some of the other parts of the country, we could see a lower cost. I

do not expect to see this cost continue to ratchet up and then eventually that is what it costs.

It would clearly be my expectation that we will see the cost estimates go up and then the estimates will come down in the course of this 10-year period when we would see the results of these contracts to be following through.

Mr. MOODY. The only reason I mentioned the interest rate is because they are so extremely optimistic by most terms.

Thank you.

Chairman ROSTENKOWSKI. Mr. Dorgan, are there any further questions?

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. WALL, you probably heard me ask the question about junk bonds and the purchases of junk bonds in the savings and loan industry. Could you give me a list of savings and loans that have been large purchasers of junk bonds?

Mr. WALL. Yes, we can, but let me, if I might, come back and make a correction on an estimate you made concerning the amount of investments. You used, as I recall, 8 to 10 percent, and it is more like 2 percent overall, and then there are, as you indicate, a limited number of institutions that have some concentration of junk bonds. But overall, it is nowhere near 8 to 10 percent. It is more on the order of 2 percent.

Mr. DORGAN. Would you support legislation that would prohibit institutions that are federally insured from making investments in junk bonds?

Mr. WALL. I do not think per se junk bond investment is a bad investment. I think it has to be underwritten just like any other kind of a commercial credit. On the other hand, the new risk-based capital formula impacts on whether or not management believes they have the expertise and the experience to invest in junk bonds successfully. Since because in order to do so will require a much higher capital requirement.

Mr. DORGAN. I would appreciate getting a list of the S&L's that have invested substantially in junk bonds.

[The information was supplied directly to Mr. Dorgan.]

Mr. DORGAN. Second, the witness this morning indicated that part of the problem has resulted from massive speculation. It seems to some of us that read the newspaper in December and January, that if in fact the problem is caused by speculation, it is incongruous that you turn to speculators to solve the problem.

Some of the deals that you have engaged in are deals with classic speculators, are they not?

Mr. WALL. I do not know, the term "speculator" as a pejorative or as a way of characterizing somebody's experience. Clearly the folks with whom we undertook partnership arrangements or contracts have significant amounts of experience.

Another one of the statistics that is much misunderstood or not recognized is in December we did 34 deals, 27 of those were financial institutions. About seven of those deals were the focus of everybody's pejorative—and I do not mean to say yours, but the press and others' pejorative criticisms. I do not think those seven deals can even be characterized in that kind of a critical sense.

Mr. DORGAN. I might tell you that the observation from someone on the outside is that it is unusual. If the problem is caused by speculation, it makes no sense to bail out even one under these circumstances. Some of the names that have been bandied around are those involved in the LBO and hostile takeover binge in this country and involved in substantial financial speculation. It seems unusual to those of us observing that you have done that.

Mr. WALL. Here was a case where we had another one of our hands tied behind our back. We had asked for the full faith and credit of the U.S. Government on FSLIC notes so as to bring all of those who are publicly reporting companies to the table. We found that those who are willing to make more of an entrepreneurial kind of investment and undertaking, were willing to make it on the basis that they have confidence in the FSLIC notes. Those who are publicly reporting companies because of the accounting profession's perspective and attitude, were not willing to make such an investment.

Mr. DORGAN. Let me take a slightly different approach. It seems to me there has been a colossal regulatory failure in the 1980's. Have we pinpointed and resolved it? Has anybody lost their job because of regulatory failure?

Mr. WALL. Oh, I think there are dozens, if not hundreds of managers of institutions around the country who have lost their jobs because of regulatory failure.

Mr. DORGAN. You have cleaned out your agency?

Mr. WALL. I am sorry?

Mr. DORGAN. You are saying there has been a clean-out of your agency of people who you think have failed the agency in regulating?

Mr. WALL. There are people no longer in the Bank Board and in the bank system. Some of the reason for their departure clearly would be the perception that—

Mr. DORGAN. What is the dimension of that clean-out? The reason I am asking the question is I think Congress made a mistake. I did not vote for the legislation that allows these thrifts to get into higher risk.

Mr. WALL. Most people misunderstand; the Congress did not vote for such legislation, the State legislatures did.

Mr. DORGAN. But my point is that some place along the line the regulators are supposed to be regulating and telling us what is happening out there. Some place along the line there was a tragic failure of regulation that is going to cost us \$50 or \$100 billion. I am trying to find out whether we have a no-fault government. Are there people who have lost their jobs because of this?

Mr. WALL. Absolutely.

Mr. DORGAN. So, what is the dimension of that?

Mr. WALL. At the State and Federal levels. In some States whole offices and divisions of State government.

Mr. DORGAN. Would you provide me with a description of that, as best you can, in writing?

Mr. WALL. Surely. I think what is more important is what was done by the predecessors of this Board. On July 1, 1985 they delegated the responsibility of examination to the 12 district banks. Limits were placed on the FSLIC as well as the FDIC the number

of examiners and supervisors. By delegating the examination responsibility to the 12 district banks, the district banks staff and the salaries doubled. They were much better equipped.

Today, the examination force for the Federal Home Loan Bank Board is superior to the bank regulatory staffs.

Mr. DORGAN. All right. Now—

Mr. WHITE. Congressman, let me add to what Dan Wall just said. It was not only people, it was inadequate regulations on the books. One of them was an inadequate networth requirement, an inadequate capitalization regulation. Indeed, the Congress back in 1980 had encouraged the Federal Home Loan Bank Board to lower the capital standards that applied to thrifts, which our predecessors at the Federal Home Loan Bank Board subsequently did. There were inadequate limits on wild growth, there were inadequate limits on direct equity risk investments by the thrift industry. But over the past 4 years those regulations have improved. We now have tighter limits on growth and much better net worth capitalization regulations, with a better set of regulations out on proposal; we have limits on direct equity risk investments that link them to a thrift networth, that link them to the capital in the thrift.

So, today we have much better regulations; but it was not only inadequate numbers of regulators, it was inadequate regulations on the books. The hands of the regulators were in many ways severely tied.

Mr. DORGAN. If that were the case and we were heading toward a problem of this dimension, and if somebody's hands were tied, you would expect them to stand on the highest mountain and scream as loud as they could. Somebody this morning said that your agency went down to the administration to ask for more staffing and OMB said no more people, at a time when you desperately needed more people. Is that accurate?

Mr. WHITE. Ed Gray did in late 1984 and early 1985.

Mr. DORGAN. Who was running OMB at the time?

Mr. WHITE. I cannot remember who the Director of OMB was. I think it was Mr. Stockman.

Mr. DORGAN. I remember reading a Fortune magazine article a while back, some years ago, about an S&L operator in California. I am talking about a high-flier. The story was amazing. As I read, I turned to somebody and said you know, this stuff just does not pass the smell test. How can they be engaged in this kind of growth, outrageous growth? As it turned out it is one of those thrifts that took a nose-dive. Somebody some place should have been raising red flags all over this town, saying we are headed toward a dangerous and disastrous fall.

My point is that we had a massive regulatory failure and I hope it is corrected. I hope some people who turned their cheek to that are gone or some people who exhibited incompetence are gone. We have new people, more aggressive people and more vigilant people in place, so that we avoid this sort of thing in the future.

Mr. WALL. I can give you a very quick response with some numbers, because it comes right to the point that you are asking about. The State of California, in the early 1980's, was in a situation where their charter was about the same as a Federal charter. They had a regulatory structure of 200 professionals. Then they saw the

number of State chartered institutions decreasing due to conversion to Federal charter. The number of regulators declined to 80. At that same time they unshackled and liberalized their charter. By January 1, 1983, there were only 80 professionals in the State of California.

As I said, there is a lot of accountability to go around, State and Federal alike, but the number of examiners in California decreased from 200 down to 80, at absolutely the worst possible time.

Mr. DORGAN. Well, thank you very much for your testimony.

Chairman ROSTENKOWSKI. Mr. Andrews will inquire.

Mr. ANDREWS. Mr. Wall, I have three questions, please. First, in looking over your testimony, I cannot tell whether or not you have taken a firm position on whether the tax benefits should be extended. I am curious, what is your position? Should we extend those benefits or should we not extend the benefits?

Mr. WALL. We believe that the question of extending or not extending the benefits is, as the chairman posed, a question that needs to be considered as part of the overall discussion. Now, I would not agree with the chairman's suggestion that it should be in the same bill. I think that the question of a commitment of resources from the Federal Government, which will be decided by the Congress and by the administration in concert, is part of the comprehensive legislative package, and includes the issues of the time when the same whether or not to extend the current level of tax exemptions, and benefits, or to increase it to the full 100 percent, or eliminate them. These issues need to be considered in the same formulation.

Mr. ANDREWS. In other words, if there is appropriate funding, whatever the funding level might be determined, if that deemed appropriate by you, then those tax benefits might not be necessary?

Mr. WALL. That is right. I think the question needs to be dealt with in its entirety, as the question has been posed to us. Only in a handful of cases can you even arguably say that the tax impact was so significant that liquidation should have been considered.

Mr. PICKLE. Will the gentleman yield?

Mr. ANDREWS. I would be glad to yield.

Mr. PICKLE. Mr. Wall, the question was will the tax provisions still be continued. For all purposes, you are out of the business. The tax provisions are still on the books, but you are not doing any more mergers or acquisitions now. I assume you have stopped the consolidations and that you are dead in the water. Is that not correct?

Mr. WALL. As Chairman Seidman indicated earlier, we collectively, are waiting for the Congress to respond to the President's proposal. But the question was whether or not the tax benefits ought to be part of or in addition to, and my response was——

Mr. PICKLE. Yes, but when we vote to give you——

Chairman ROSTENKOWSKI. What was your response?

Mr. WALL. My response is that I think the tax benefit should be a consideration, as you indicated in your opening statement. However, in all due respect, I do not think it should necessarily be in the same bill. The discussion should include whether tax benefits will be extended; how much of the burden will be shouldered by the Federal Government; and how much of the burden will contin-

ue to be the obligation of the industry. Today, as the law exists, the industry has all of the responsibility.

Mr. PICKLE. Mr. Chairman, Mr. Andrews has the time. I will yield back to Mr. Andrews and he will yield to the chairman. I am just simply saying to you that you are saying when we give you \$50 billion to create another quasi agency, then you might go back to having some more acquisitions, if the tax incentives are continued and if we say that is good. So, you are waiting on us to give you \$50 billion and then you will proceed. In the meantime, there are no acquisitions, you are stopped.

Mr. WALL. Yes.

Mr. PICKLE. And the FDIC may or may not. Can you, Mr. Seidman, do acquisitions and mergers now?

Mr. SEIDMAN. We can do them with banks, but we—

Mr. PICKLE. But not with savings and loans?

Mr. SEIDMAN. Not with savings and loans, unless they are unassisted.

Mr. PICKLE. Thank you, Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Wall, we have no obligation to have legislation at the end of the year with respect to extending these provisions. What concerns this committee is if we do not put it in the package now, if we do not get from the Banking Committee what their intentions are, and you come to us or the administration will suggest to us later in the year that we include this or that we create legislation that will provide for these extensions, how do we pay for them? That is what concerns us. Now, if the administration wants to make a recommendation now, I view it as putting a package together where we can recognize what the costs are going to be. We are going to have one hell of a time this year trying to meet our obligations with respect to this deficit reduction that everybody is talking about, and all I want to do is get some perspective on just what the dollar cost is going to be, because every time we make these benefits available, we are talking about larger deficits. I think that it is an obligation on the part of this committee, in conjunction with working with the Budget Committee, to try and get a focus on what we are trying to do.

Mr. WALL. I certainly understand what you are saying Mr. Chairman. I think I must have misunderstood the thrust of your opening comment. I certainly agree with the point you just made. It has to be one and the same kind of consideration.

Now, again, I will say with respect to whether it is one bill, I do not know, because you get into problems with the tax committees having more authority than other committees.

Chairman ROSTENKOWSKI. Well, I think what we have to hear is what are the packages that we are going to try to legislate going to cost us, and I think the sooner we get those estimates, the better off we are, so that when we get to this day of reckoning around August and we are going to pass a debt ceiling bill here, we are going to have a perfect view of what the picture is with respect to funding that we are going to have to furnish.

Mr. Andrews.

Mr. ANDREWS. In that regard, can we anticipate that if this committee hears a specific position from you on this matter of extension of tax breaks?

Mr. WALL. As the chairman has suggested, and I think you at the outset of your first question stated, I think the issue is really more an administration's recommendation rather than an independent agency's.

Mr. ANDREWS. Can anticipate hearing a position from you, an observation, about those recommendations to give this committee some guidance in formulating policy?

Mr. WALL. As this debate and discussion goes forward, I think that it is reasonable to expect, yes.

Mr. ANDREWS. A second area I would like to ask you about is a particular problem in Texas right now, and that is some of the ailing S&L's in Texas have increased their interest rates to attract dollars. And this has happened, it has worked. They have attracted a lot of money into those institutions that may already be in deep trouble.

The fact is disturbing that, first of all, it may increase the ultimate costs of the problem if they—those S&L's go under. And second, it may increase the cost of solvent S&L's, the S&L's that are profitable. And I want to know your view about this. I am curious what you or Mr. Seidman think the impact may be on the economy in general, an economy like Texas or Florida, or other States, California, that are deeply impacted by this issue. But secondly, what should we do about it? What response should we have if any?

Mr. WALL. We believe the results of our activities in 1988 had a significant positive effect on bringing down what was called the Texas premium, that is the amount that was having to be paid in interest costs above the market for interest costs elsewhere in the country. What is clearly in the minds of the depositing public and in the market is how long will it be before Congress decides to act. There are some who are now concerned that the rates might go up.

I might call on Board Member Martin for a minute just to describe what the current status is versus what it was a year ago.

Mr. MARTIN. Basically what has transpired is that while the Treasury rates have gone up for the first 9 months of last year, about 124 basis points, the cost of savings the Texas institutions went down 25 basis points. You have or rather used to have the Texas premium around 89 basis points. It's probably running now about 40 or 45 basis points. The high rate payers now, other than the two you mentioned, are regrettably Texas banks. They are the big players.

The two institutions that started this rate war were moved into conservatorships. They were slated to be put together in a package and disposed of by the end of March by FSLIC. They are two troubled institutions.

Mr. WHITE. Congressman, you asked what should the Congress do—

Mr. ANDREWS. Now, now wait, Mr. White. The question is does this trouble you? Should we give great concern to this, and what should the response of our committee and the Congress be?

Mr. WHITE. I would say, Congressman, that the best thing that you could do is to pass some version of the President's proposal so as to get funding to the FDIC just as quickly as possible, so that the FDIC can get moving and dispose of these insolvents either by finding acquirers or by liquidating, however they see fit. Because getting the insolvents out of the picture is going to be the best thing to be dealing with these—

Mr. ANDREWS. Mr. Martin, in Houston in particular, what do you see the impact of this—

Mr. MARTIN. Well, the impact is substantial. 10 basis points nationally for the savings and loans costs \$1 billion pretax and would also cost the banks \$2 billion. So it is a horrendous problem. At one point the high payers were paying about 170 basis points over the comparable Treasury for no reason at all. That average now is about 60 basis points.

And that had a tremendous impact. If that spread opens up again, it is going to be a disaster.

Mr. ANDREWS. One more question, Mr. Wall. With regard to potential buyers and investors, groups that want to participate, what are your thoughts about what actions they should take? I understand we are in a holding pattern, but how should they view their status in whatever degree they have been involved in trying to buy some of these ailing S&L's?

Mr. WALL. Well, we are in a contractual relationship with the FDIC. And one of the things that Mr. Seidman and I talked about a couple of weeks ago and I have begun the initial stages of doing, is transferring our qualified bidders list to them and providing them with the files on all of those people who are on our qualified list.

As I indicated earlier, FDIC does not have an unlimited opportunity for people to acquire their institutions. The law is different for a commercial bank. So FDIC needs the files we have and I am sure they would be anxious to hear from interested bidders.

Mr. SEIDMAN. Mr. Andrews, I just want to make a point. As far as the funding goes, if these institutions that are being taken over now cannot obtain funds as close to the regular market levels, then there are alternative sources of funding available from the Home Loan Banks and the Federal Reserve system. So overall, these institutions will not be driving the rates up any material amounts.

Mr. ANDREWS. Thank you.

Thank you, Mr. Chairman.

Mr. PICKLE. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. Mr. Wall, earlier you said that these mergers and acquisitions had brought in new capital to the Southwest in particular.

Mr. WALL. In 1988? \$1.2 billion for the entire year.

Mr. PICKLE. I thought you said you knew capital was somewhere around \$5 billion?

Mr. WALL. \$3 billion nationwide for 1988. For Texas alone, \$1.2.

Mr. PICKLE. All right. Then that is more in line with what I had. But I thought you were saying \$5 billion in Texas alone?

Mr. WALL. No.

Mr. PICKLE. And I wanted to see the list. I would like to have the list of the Texas mergers anyway.

Mr. WALL. Fine.

Mr. PICKLE. To see the capital.

Mr. WALL. It is in our answers to several of the questions, but we will point those out to your staff.

[The information follows:]

JIM MOODY
WISCONSIN

COMMITTEE ON
WAYS AND MEANS

Congress of the United States
House of Representatives
Washington, DC 20515

1019 LONGWORTH BUILDING
WASHINGTON, DC 20515
(202) 225-3571

135 WEST WELLS ST.
ROOM 518
MILWAUKEE, WI 53203
(414) 291-1331

February 24, 1989

The Honorable M. Danny Wall
Chairman
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Chairman:

This letter is to follow up your testimony before the Ways and Means Committee this week.

You obviously disagree with portions of the GAO report entitled "Troubled Financial Institutions: Solutions to the Thrift Industry Problem." In your testimony you stated that there were misconceptions regarding yield maintenance agreements and other incentives for acquired thrifts to be productive.

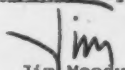
Through the Bank Board deals, I believe that in newly acquired thrifts the federal government is now committing itself to far more than \$100,000 on each deposit. This may be detrimental to healthy thrifts. Could you please elaborate on your comments on the GAO report?

Also, the Administration has made some very optimistic assumptions regarding future interest rates. How sensitive do you think interest rates will be to the Administration's proposal to raise \$50 billion in bonds? Recent articles state that the total cost will be much higher than previous estimates. Will we need to issue more bonds and will this have a further effect on interest rates? If you believe that interest rates are in fact sensitive, should the Administration revise its economic forecast?

This is a very difficult issue to get a handle on. Your responses will be very helpful and much appreciated.

Thank you for your assistance.

Sincerely,


Jim Moody
Member of Congress

Federal Home Loan Bank Board
OFFICE OF THE CHAIRMAN

M. DANNY WALL, Chairman



1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

04 MAR 1989

Honorable Jim Moody
House of Representatives
Washington, D.C. 20515

Dear Congressman Moody:

Thank you for your recent letter, in which you raise some questions relating to my testimony before the Ways and Means Committee. I appreciate the opportunity to clarify any points that came up during the February 22 hearing.

Before answering your specific questions, I would like to respond to your concern that assistance provided by the Federal Savings and Loan Insurance Corporation (FSLIC) may dampen the productivity of acquired thrifts because FSLIC assistance lacks incentives. I believe that FSLIC assistance provides more than adequate incentives to the managements of acquired thrifts for a number of reasons.

First, not all assets of acquired thrifts are covered by FSLIC assistance. In all FSLIC-assisted transactions, a substantial inventory of assets remains exposed to market forces. Energetic, intelligent management is required to derive profits from these assets -- they offer a challenge even to the most talented management team.

Perhaps equally important, acquirers usually must place their own capital at risk to receive FSLIC assistance. In the Southwest alone, acquirers brought over \$1 billion of their own capital into the industry in 1988. Nationwide in 1988, acquirers put up \$3 billion of their own capital.

Specific provisions in FSLIC assistance agreements create incentives to maximize returns even on covered assets. For example, loss sharing and gain sharing are features of some assistance agreements. Under these provisions, the acquirer absorbs some of the loss if a covered asset is sold below a given price, and shares in the upside if it is sold above a specified price. These provisions reinforce incentives to minimize loss and maximize returns on assets.

Mr. PICKLE. All right.

I think the FSLIC has put precious little capital into these new ventures. You have been slow to come by it. It has not been a rip-off for the big money people as much as people think or they would have gotten into this thing a year ago. They may get an awfully sweet deal if the economy starts pulling up and everything comes around the corner. If it does not, they have lost millions of investment.

We are inviting them, that is the only way you are going to get them.

What concerns me now at this stage is what is going to happen to the institutions that are marginally questionable. We have many institutions in my Southwest area that were ready to be acquired, trying to be acquired, trying to put together deals. Now, they are stopped. I do not presume then, Mr. Seidman, that either one of you can do anything about it.

If FDIC intends to merge some more, if you have authority, I would like to know that. I do know that a lot of these marginally solvent, marginally profitable, S&L's just are keeping their heads above the water, and did not cause this problem in the first place. They are going to go under if you keep increasing the premiums.

If the recommendation made by the President goes into effect, we—the Congress put up the \$50 billion, and that is very questionable because we do not know where in the world we are going to get the money to do. But assuming we did, you are going to have to put a heavy premium on these little institutions.

Now, a lot of them are just staying alive now. If you increase their premiums sizably, that is going to send them under. It seems to me like we ought to find some way at this stage of the game still to have some of these marginally solvent institutions, whether it be S&L's and/or the banks. Whatever has happened to the S&L's, the banks are not far behind. So I would hope that you all could give some attention to that because I think it is critically important.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you gentlemen, thank you for joining us. It has been most helpful.

Mr. WALL. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Blum.

Mr. Blum, thank you very much for joining us. Welcome to the committee. I am sure that we are going to see quite a lot of you over a period of the next 2 years.

If you are ready to begin your testimony, the committee is ready to receive it.

STATEMENT OF JAMES L. BLUM, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. BLUM. Thank you, Mr. Chairman.

I am very pleased to appear before the committee to discuss the savings and loan problem. CBO has prepared for the committee a 34-page background memorandum on the economic and budgetary issues, and I have a prepared statement which I would like to submit for the record.

Chairman ROSTENKOWSKI. Your entire statement, Mr. Blum, will be included in the record. If you wish to summarize it, please do so.

Mr. BLUM. I would like to do so, Mr. Chairman, in the interest of time.

First, let me turn to the issue of the size of the problem. The ultimate cost of resolving the problem is very uncertain, as the committee has heard extensively this morning. CBO has not made its own independent estimate, but we have examined estimates that have been made by others, including the FDIC, GAO, and various private-sector experts.

For the most part, these various estimates point to a present value cost of at least \$100 billion. This includes the cost of those thrifts already dealt with as well as the remaining 350 insolvent thrifts. It also includes funds to replenish the reserves of the FSLIC insurance fund.

Part of these costs have already been paid for. FSLIC disbursed \$16 billion in cash from 1986 to 1988 for case resolution. That leaves about \$85 billion, at least, that remains to be spent. The administration's plan announced this month projects assistance in present value terms of roughly this amount. So it appears that the administration's plan would provide sufficient resources to do the job. If the costs turn out to be greater, the administration's plan calls for additional resources to be provided by the Treasury.

I will deal first with the impact on the budget. As a Government entity, FSLIC's activities are included in the Federal budget. It's income and expenditures are recorded in a revolving fund on the outlay side of the budget. Income from assessments, investments and liquidations is used to pay insurance and administrative costs.

Until the early 1980s annual receipts to FSLIC were generally greater than its expenditures, so that it had net negative outlays and it helped reduce the deficit. Since 1985 FSLIC net outlays have been positive, reaching \$8.1 billion in fiscal year 1988. For the current year, FSLIC's net outlays are expected to exceed \$10 billion.

The administration's proposal is designed to minimize the budgetary impact of solving the S&L problem during the next few years and to avoid any additional problem in meeting the Gramm-Rudman-Hollings deficit targets.

A major part of the administration's plan is to create an off-budget agency, the Resolution Financing Corporation, that would borrow \$50 billion in the private credit markets over the next 3 years. In major respects, this new agency is modeled after the financing corporation that was created by the Congress in 1987 to raise \$10.8 billion for FSLIC.

Under the administration's proposal, the proceeds from the REF-CORP borrowing, \$10 billion in 1989, \$25 billion in 1990, and \$15 billion in 1991, would be recorded in the budget as offsetting collections or negative outlays. I would refer to table 1 in my prepared statement that appears immediately following page 6.

These proceeds would help to offset the \$87 billion in disbursements to be made by FSLIC or the new Resolution Trust Corporation. As a result, the administration projects only \$18 billion in net budget outlays for FSLIC and the RTC during 1989 through 1991, with the bulk of the net outlays occurring in 1989. Estimated net

budget outlays for 1990, for example, in the Bush budget are only \$1.4 billion.

The administration's plan also calls for raising premiums that banks and thrifts pay for deposit insurance, though these increases will contribute little to the cost of solving the S&L problem. The administration estimates that the increase in the FDIC fees would generate \$7.9 billion over the 1990 to 1994 period and another \$12 billion in the following 5 years, to bolster FDIC reserves. These receipts would help reduce the budget deficit, but they would not be used for the S&L problem.

Most of the other cash needed under the administration's plan would come from the Treasury. This would include funds to pay for the bulk of the interest costs on the REFCORP borrowing as well as to cover any cost shortfalls in the FSLIC and RTC operations and to provide additional reserves. Whether these Treasury funds would be subject to annual appropriations or would be provided through a permanent borrowing authority is not known at this time.

With respect to the impact on the economy, by opting to raise funds primarily by borrowing, the administration's plan should not have a significant adverse effect on the economy. In view of the need for large amounts of funds quickly, raising the full amount of needed funds through a large temporary increase in taxes would not be efficient and would risk disruption to the economy.

Any increase in interest rates because of the increased supply of funds should be temporary and not large. The rescue funds most likely would be used by the S&L's to purchase income-yielding assets such as Government bonds, mortgages, and other types of assets. This use of the rescue funds should offset any initial interest rate increase.

In addition, interest rates should be held down by the relative decline in rates on bank and thrift deposits. Since the insolvent thrifts would no longer need to offer premium rates to attract ever-increasing deposits to fund their losses, the remaining thrifts could lower what they have to pay depositors.

I will turn next to the issue of the budgetary treatment of debt financing, normally Federal borrowing does not appear in the budget as an offsetting collection. If it did, we would not have a deficit problem. Yet this is exactly the treatment that is proposed by the administration for the \$50 billion in funds to be borrowed by REFCORP which nominally is an off-budget entity but has many of the attributes of a Government agency.

Mr. Chairman, I am sympathetic with the administration's proposal to avoid a budgetary impact, because I believe that a good case can be made that the spending of these funds can be distinguished from most Government spending in that it virtually has no economic impact. The outlays for which the debt would be issued are not likely to reduce private investment by diverting private savings to consumption. These funds probably would be returned to the lending stream. Under these circumstances, reducing spending in other Government programs, or raising taxes because outlays to resolve the S&L problem breach the Gramm-Rudman-Hollings deficit targets, could result in a much greater contraction than envisaged by the Balanced Budget Act.

A less costly way of providing the proposed \$50 billion in additional funds would be to have the Treasury do the borrowing rather than an off-budget agency. Interest expenses would be reduced by \$100 to \$200 million a year. Moreover, using Treasury financing should permit the Government to move more quickly to resolve the S&L problem. Establishing a separate financing corporation and a secondary market for securities could be a time-consuming process.

Of course, this would mean that the budget outlays would not be offset by the \$50 billion in borrowed funds, and the deficit would be higher. But the additional spending could be exempted from the Gramm-Rudman-Hollings deficit calculations in the same way that asset sales are now excluded from these calculations. In fact, this spending is completely analogous to asset sales. Asset sales are correctly perceived as not reducing the deficit, and the spending of the \$50 billion does not really add to the deficit in an economic sense.

This argument does not apply to interest expense that results from the debt issue to finance the rescue plan, however. It is just like any other interest spending that is included in the budget. Accordingly, the interest payments should not be exempted from the Balanced Budget Act targets.

The administration chose to go to the off-budget agency borrowing so as not to set any precedents by exempting the spending from Gramm-Rudman-Hollings, but going this route also sets dangerous precedents for other off-budget proposals. This was done successfully last year, for example, with the farm credit system bailout. An unsuccessful attempt was made to create a new Government-sponsored enterprise to take over the loan and guarantee functions now performed by the Small Business Administration.

Thus, the administration's approach could accelerate a trend toward transferring Government functions to off-budget Government-sponsored enterprises to the detriment of Federal budgetary control and to executive and legislative branch oversight.

The appropriate budgetary treatment for financing a solution to the S&L problem is ultimately a matter that should not be settled by the staffs of CBO and OMB, but it is a political question that should be decided by the Congress and the President.

My statement discussed two other issues, the existence of certain tax preferences that are supposed to reduce the cost of resolving insolvent thrifts, and the importance of regulatory reform to avoid future losses.

The first issue is that of tax preferences. These were extended through 1989, as has been discussed today, in a more limited form by the Technical and Miscellaneous Revenue Act of 1988. They have been used by FSLIC in resolving the S&L problem through assisted acquisition by other firms. The added financial resources to be provided through the administration's plan should relieve FSLIC's cash shortage and reduce the need for the use of these tax preferences.

Furthermore, it is doubtful that the Government receives the full value of the tax benefits through lower outlays by FSLIC. Therefore, the tax preferences most likely increase the ultimate cost of solving the S&L problem. They may also have the unintended effect of having insolvent thrifts acquired by those who are seeking

the greatest tax gain, rather than by those who might operate the thrifts most efficiently.

The thrift crisis already has been quite costly to the U.S. economy. To say that resolving the S&L problem will cost \$100 billion is to say that the capital stock of the United States is that much smaller, and as a result, that national incomes now and in the future will be lower.

While my previous remarks focused largely on paying for the loss that has already occurred, great importance should be attached to creating a regulatory and deposit insurance system that limits future losses and prevents future crises from developing.

The best way to prevent the costs of currently insolvent thrifts from increasing is to close them quickly. These thrifts would then be unable to make more bad investments or drive up interest rates as they seek to fuel their ever-increasing operating losses with ever-increasing deposits. It is, nevertheless, also critical to move ahead with regulatory reform that would reduce the incentives and ability of thrifts to act imprudently in the future.

The administration has proposed a significant overhaul of the existing regulatory apparatus. It also proposes treating thrifts more like banks by raising their capital requirements. A higher capital standard not only reduces the incentives to make risky investments, but it also provides a cushion for the deposit insurer in case the institution experiences financial difficulty.

Regulatory reform has many dimensions that may take some time to sort through. If addressing this issue were to slow the closing of insolvent thrifts, the ultimate cost of the S&L problem could increase. It may be desirable, therefore, to consider regulatory reform separately from the resolution of insolvent thrifts but this is another issue that is primarily political in nature and that is also—that is similar to the budgetary treatment to be used for financing the solution.

Mr. Chairman, that concludes the summary of my statement and the longer staff memorandum that we provided for the committee. I would be happy to answer any questions that you might have.

[The statement of James L. Blum follows:]

STATEMENT OF JAMES L. BLUM,
ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to appear before this Committee to discuss the financial difficulties of the savings and loan industry, and the budget and policy implications of providing federal assistance to resolve the problem. My testimony today will summarize the material presented in a Congressional Budget Office (CBO) staff memorandum prepared for the committee entitled The Savings and Loan Problem: A Discussion of the Issues. More specifically, my statement focuses on three major areas discussed in the CBO paper:

- o The size of the problem and the need to move quickly to resolve it;
- o The Bush Administration's proposal and its impact on the budget; and
- o Issues to be addressed by the Congress, including the financing of a solution and avoiding future problems.

THE SIZE OF THE PROBLEM

Although the Federal Savings and Loan Insurance Corporation (FSLIC) dealt with more than 200 bankrupt thrifts in 1988, the crisis is far from resolved. More than 300 insolvent thrifts still remain open, and many solvent thrifts are financially weak. Because FSLIC itself is insolvent, it has resorted to a variety of creative financing methods in dealing with many of the thrifts acquired with FSLIC assistance, and in the process, it has committed its premium income for many years to come. FSLIC has also left open many questions about both the final cost and the survival of some of the thrifts that have been acquired with government assistance.

To resolve an insolvent thrift, the government must eliminate the gap between the institution's liabilities and its assets. In other words, the government must ensure that assets earning sufficient returns back insured deposits. The ultimate cost of resolving the thrift crisis, therefore, will be roughly equal to the combined negative net worth—the difference between the market value of assets and liabilities—of all insolvent thrifts when each thrift is resolved. The rate at which the net worth of the remaining insolvent thrifts deteriorates reflects the cost of delaying a resolution.

Estimating the ultimate cost of a resolution, however, is extremely difficult. It is even difficult to determine the cost of resolving many institutions that have already been dealt with, the fundamental reason being that thrifts report the book value of their assets—which is based on their historic cost—while the government's liability depends on the market value of those assets. For specialized assets, like incomplete office buildings and idle equipment, only a sale can establish the market value, and it may take years before all the assets are sold. In addition, payments on the notes and guarantees that FSLIC issued when it resolved many of the institutions depend on future interest rates and asset values, as well as on the timing of asset sales.

FSLIC estimates that it has committed \$38 billion, in present value terms, to resolve nearly 300 thrifts over the past three years. In addition, FSLIC states that acquirers of insolvent thrifts received, on a net present value basis, more than \$5 billion in tax preferences for deals made in 1988 alone. As the result of its efforts, FSLIC has not only exhausted its reserves, but has also more than committed its future premium income, though substantial costs remain to be met. Moreover, a significant segment of the industry, although solvent, is thinly capitalized and not profitable. Indeed, many of these thrifts are likely to become insolvent over the next several years, and so resolving the thrift crisis will also entail dealing with these institutions. Finally, FSLIC must replenish its reserves.

A number of estimates of the cost of the thrift crisis have been made, though they must be viewed with caution. For the most part, they entail a present value cost of at least \$100 billion. This amount includes the cost of resolving financially weak thrifts, as well as those that have already been acquired or liquidated. It also includes funds to, at least partly, replenish the reserves of the FSLIC insurance fund. Part of these costs have already been paid for; FSLIC disbursed \$16 billion in cash from 1986 to 1988 for case resolution. Thus, if the total cost of the problem is in the range of \$100 billion, the federal government would need to spend about another \$85 billion in net present value for these purposes. The Administration projects assistance under its plan of roughly that amount. If costs turn out to be greater, however, the Administration's proposal calls for additional resources to be provided by the Treasury.

It is imperative that the problem be dealt with quickly. A major reason for the enormity of the current crisis is that these institutions can continue to operate even when they are insolvent. Because of federal insurance, they have little trouble attracting deposits. They use these funds not only to cover their operating losses, but more significantly they can use them to make additional investments. And because they are insolvent, these thrifts have an incentive to engage in overly risky activities; they only profit from a successful investment if it generates a large payoff. Thus, moving quickly to deal with insolvent thrifts will reduce the total cost of resolving the problem.

THE BUSH ADMINISTRATION'S PROPOSAL AND ITS IMPACT ON THE BUDGET

The Bush Administration recently announced its plan to deal with the industry's current difficulties. Most of the reforms proposed by the Administration's plan require legislation, however, and hence the Congress will have a number of policy and budget issues to examine in the context of developing a rescue plan.

A major part of the Administration's plan involves raising \$50 billion in the private credit markets. These funds, along with direct Treasury payments for any additional cash shortfalls in the insurance fund, would be used to pay for previous commitments as well as to close all currently insolvent thrifts over the next three years. (Much smaller amounts come from the retained earnings of the Federal Home Loan Banks and increased insurance premiums.) The Administration's plan also includes provisions that would strengthen the regulatory and insurance structure of the savings and loan industry to limit risktaking and to restore solvency to the fund.

Within days of announcing this plan, the Federal Home Loan Bank Board, which operates FSLIC, contracted with the Federal Deposit Insurance Corporation (FDIC) to give FDIC control of thrifts that are insolvent. Examiners from several federal agencies are forming teams to help FSLIC stabilize these thrifts. The Bank Board has also suspended sales of insolvent institutions, although it is still liquidating some of them.

While the Administration's plan seems to provide sufficient resources, it is important to consider whether it proposes to raise the funds in the least costly way. The Administration would largely finance the resolution with a mixture of on- and off-budget borrowing. It proposes creating the Resolution Financing Corporation (REFCORP)—an off-budget agency—to borrow \$50 billion in fiscal years 1989, 1990, and 1991. In many respects, REFCORP would be similar to the Financing Corporation (FICO), an off-budget agency, created by the Congress in 1987 to raise \$10.8 billion for FSLIC. The principal on the REFCORP bonds would be paid by purchasing U.S. Treasury zero coupon bonds that, upon maturity, would be worth \$50 billion. The interest payments account for almost all of the cost of this debt. They would be paid in part from FSLIC receipts and Federal Home Loan Bank retained earnings, but they would be paid mostly from the Treasury. By the Administration's estimates, Treasury would cover \$6 billion of the \$17 billion in interest due in the 1989-1994 period, and at least \$16 billion of the \$19 billion to be paid in each five-year period thereafter.

The Administration's proposal, like the existing FICO arrangement, is structured to minimize the budgetary impact in the initial years. It would accomplish this by treating REFCORP as off-budget and by recording the \$50 billion raised by REFCORP as offsetting collections to FSLIC or to the new Resolution Trust Corporation (RTC), which would resolve the insolvent thrifts insured by FSLIC. As shown in Table 1, this treatment would result in large collections offsetting heavy spending in 1989, 1990, and 1991. Disbursements by FSLIC and RTC would total over \$87 billion in that three-year period, but only \$18 billion would be scored as budget outlays by these agencies, mostly in 1989.

President Bush's proposal also provides added revenues by increasing the fees that both banks and thrifts pay for deposit insurance, though these increases would contribute little to the cost of resolving the crisis. The Administration estimates that the increase in FDIC fees would generate \$7.9 billion over the 1990-1994 period and another \$12 billion in the following five years to bolster FDIC reserves. These

TABLE 1. FSLIC/RTC AND TREASURY NET OUTLAYS FROM BUSH PROPOSAL: REFCORP Borrowing Off-Budget (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989- 1994	1989- 1999
FSLIC/RTC								
Disbursements ^{a/}	27.7	33.4	26.0	10.4	11.0	8.2	116.5	141.5
FSLIC/RTC Col. ctions								
Proceeds from REFCORP	-10.0	-25.0	-15.0	0.0	0.0	0.0	-50.0	-50.0
Other ^{b/}	<u>-7.0</u>	<u>-7.0</u>	<u>-5.0</u>	<u>-5.8</u>	<u>-6.3</u>	<u>-5.9</u>	<u>-36.9</u>	<u>-53.6</u>
Total Collections	-17.0	-32.0	-20.0	-5.8	-6.3	-5.9	-86.8	-103.6
FSLIC/RTC Budget Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Treasury Payments for REFCORP Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0

SOURCE: Office of Management and Budget.

NOTE: This table assumes that REFCORP is off-budget and that its payments to FSLIC are treated as offsetting collections as proposed by the Administration. The table is based on Administration projections of expenditures and receipts for the various items; it does not reflect CBO economic assumptions or any other possible reestimates. The Administration's figures also do not include any estimates for revenue losses to the Treasury resulting from tax benefits.

- a. Disbursements include payments for old and new cases, as well as use of assessment and liquidation income to purchase zero coupon securities and to pay interest on REFCORP bonds.
- b. Other collections include proceeds from FICO borrowing, plus income from old and new liquidations as well as current and proposed assessments.

receipts would reduce the budget deficit, but would not provide resources for thrift resolutions. The proposed assessments on thrifts would increase receipts by only \$0.4 billion through 1994, and would result in reduced assessment income thereafter.

Most of the other cash needed under the Administration's plan would come from the Treasury. Including its portion of the interest on the REFCORP bonds, the Treasury would provide about \$31 billion to FSLIC and RTC from 1989 to 1994, in order to cover their cash shortfall and provide additional reserves. Another \$48 billion would come from the Treasury in the following five years to pay off previously issued notes (\$19 billion), pay REFCORP interest (\$16 billion), and cover other cash needs.

The Administration's plan, scored in this way, would result in lower outlays than the Reagan budget over the 1989-1994 period. Although 1989 outlays would be increased by \$2.4 billion, they would be reduced by \$5.0 billion over the next five years (see Table 2). This reduction in outlays stems, in part, from the increase in the FDIC assessment, which the Administration estimates would bring in close to \$8 billion over the five-year period. The Administration's proposal, excluding the change in FDIC assessments, would increase net budget outlays by \$0.7 billion in 1990, and by \$5.5 billion over the 1990-1994 period.

By opting to raise funds primarily by borrowing, the Administration's plan meets one major objective of a successful rescue. In view of the need for large amounts of funds quickly, raising the full amount through large temporary increases in taxes would not be efficient and would risk disruptions to the economy. Major changes in taxes may generate substantial adjustments in private expenditures and could lead to sharp changes in economic activity. Relying on debt finance does not pose such problems.

In fact, issuing debt to resolve insolvent thrifts should not have a significant adverse effect on the economy. Any increase in interest rates because of the increased supply of bonds should be temporary and not large. The rescue funds would most likely be used to purchase income-yielding assets such as government bonds, mortgages, and other types of assets; this use of the rescue funds should offset any initial rate increase. In addition, interest rates should be held down by a relative decline in rates on bank and thrift deposits. Since insolvent thrifts would no longer need to offer premium rates to attract ever-increasing deposits to fund their losses, the remaining thrifts could lower what they have to pay depositors.

Although it seems desirable to finance the rescue plan with borrowing, there is no escaping the fact that such a solution raises the structural budget deficit—interest on Treasury or agency bonds will have to be paid. Financing such interest payments with additional debt would cause the cost of the overall rescue to grow at a compounded rate, and would raise an already large structural deficit. The only way to avoid such an outcome is to impose new taxes or fees or to reduce spending. The Administration's proposal does not identify the revenue sources or cuts in spending on other programs to cover the interest expense of the added debt. The only revenues generated by the proposal are the added insurance premiums paid by the banks and thrifts.

The source of the borrowing is another issue raised by the Administration's proposal. Under the plan, a government-sponsored enterprise, REFCORP, would raise funds for resolving the crisis. Proceeds to FSLIC directly offset agency spending and thus have no effect on the budget deficit. The primary reason for this arrangement would seem to be to reduce the budgetary impact of the proposal so as to avoid the deficit ceilings imposed by the Balanced Budget Act.

A good case can be made that spending on the FSLIC rescue can be distinguished from most government spending and thus should not be governed by the Balanced Budget Act. The outlays for which the debt would be issued are not likely to reduce private investment by diverting private saving to consumption. These funds would probably be returned to the lending stream. Under such circumstances, reducing spending in other programs or raising taxes because outlays to resolve the thrift crisis lead to a breach in the deficit targets would constitute a much greater contraction than the Balanced Budget Act envisioned.

It would, however, be less costly to exempt the \$50 billion in expenditures on resolving insolvent thrifts directly rather than by creating an off-budget agency such as REFCORP. Moreover, this exemption would be consistent with the treatment of

TABLE 2. BUDGET IMPACT OF BUSH PROPOSAL COMPARED WITH REAGAN BUDGET, Assuming REFCORP Borrowing Off-Budget (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989- 1994
Outlays for Deposit Insurance, Reagan Budget							
FSLIC	8.7	2.1	6.6	4.9	4.9	3.4	30.6
FDIC	<u>3.8</u>	<u>-1.3</u>	<u>-1.9</u>	<u>-2.6</u>	<u>-2.6</u>	<u>-2.7</u>	<u>-7.3</u>
Total Outlays	12.5	0.8	4.7	2.3	2.3	0.7	23.3
Changes Resulting from Bush Proposal							
Net Outlays of FSLIC/RTC	2.0	-0.7	-0.6	-0.3	-0.2	-1.1	-0.9
Additional FDIC collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	-7.9
Treasury interest to REFCORP	<u>0.5</u>	<u>1.4</u>	<u>1.6</u>	<u>0.9</u>	<u>0.8</u>	<u>1.1</u>	<u>6.3</u>
Change in Outlays	2.4	-0.2	-0.6	-1.1	-1.2	-1.9	-2.5
TOTAL OUTLAYS: BUSH PROPOSAL	14.9	0.6	4.1	1.2	1.1	-1.2	20.8

SOURCE: Office of Management and Budget.

NOTE: This table assumes that REFCORP is off-budget and that its payments to the FSLIC are treated as offsetting collections as proposed by the Administration. The table is based on Administration projections of expenditures and receipts for the various items; it does not reflect CBO economic assumptions or any other possible reestimates.

asset sales by the Balanced Budget Act. In resolving the thrift crisis, the Administration would be making the implicit liabilities of FSLIC into an explicit liability of the government—that is, it would be exchanging one liability for another. Thus, the proposed borrowing would be similar to asset sales by the government; such sales involve the exchange of one asset for another—cash. Asset sales are generally not counted toward deficit reduction targets under the Balanced Budget Act.

This argument does not apply to the interest expense that results from the debt issued to finance the rescue plan. Accordingly, the interest payments should not be exempted from the Balanced Budget Act targets. The Administration's proposal includes these interest payments both in the budget and in computing the budget deficit under the Balanced Budget Act.

Keeping the financing of the thrift crisis on budget has several desirable attributes. The most obvious is that the interest cost on Treasury debt is lower than that on government-sponsored enterprises. In the case of REFCORP, interest expenses would be reduced by \$100 million to \$200 million a year. Moreover, using Treasury financing should permit the government to move more quickly to resolve the problem. Establishing a separate financing corporation and a secondary market for its securities could be a time-consuming process. Given the need to resolve the remaining insolvent thrifts quickly, the cost of those delays as a result of issuing bonds through REFCORP could be substantial.

The appropriate budgetary treatment for financing a solution to the savings and loan problem is ultimately not a matter to be settled by staff at CBO or the Office of Management and Budget, but a political question to be decided by the Congress and the President. Any legislation that provides additional resources to FSLIC should explicitly stipulate the budgetary treatment of any debt financing used in an assistance plan.

OTHER ISSUES

I would like to touch on two other issues today. The first relates to the existence of tax preferences that are supposed to reduce the cost of resolving insolvent thrifts. The other issue involves the importance of regulatory reform.

Tax Preferences

FSLIC has used two basic methods to fill the gap between an insolvent thrift's liabilities and its assets. The first method is simply to liquidate the institution. While in practice a liquidation can take a variety of forms, in its simplest form, FSLIC pays off the various deposits and then collects the proceeds from the sale of assets of the defunct thrift. In the second method of resolving a thrift, FSLIC provides financial assistance to another firm to acquire the insolvent thrift. FSLIC has tended to emphasize such assisted acquisitions because, among other things, its resources are limited and because the Congress has provided tax advantages that can only be used in acquisitions. The added resources proposed by the Administration should relieve the constraint on FSLIC. Consequently, the Congress may want to reconsider these tax preferences.

FSLIC payments to assist an acquirer of a troubled thrift are not considered taxable income for purposes of the regular corporate income tax. In addition, other tax provisions make it easier for an acquirer of an insolvent thrift to reduce current and future tax liabilities by using the insolvent thrift's net operating losses (NOLs) in previous years. The acquirer can similarly use built-in capital losses—that is, capital losses that are not realized for tax purposes at the time of acquisition.

Permitting acquirers to limit their tax liabilities through the use of these NOLs and built-in capital losses may have undesirable consequences. These tax benefits almost certainly raise the cost to the federal government of resolving the savings and loan problem; in addition, they could create perverse incentives that may harm the industry. By lowering the amount of NOL and capital loss deductions that acquirers of insolvent thrifts were permitted to take, the Technical and Miscellaneous Revenue Act of 1988 reduced but did not remove this distortion.

It is doubtful that the government would receive even the full value of the tax benefits. If the number of potential acquirers was large and FSLIC had reliable information about the current and future tax status of each potential acquirer, FSLIC would be in a favorable bargaining position. In such a situation, it would be able to ensure that its assistance payments reflected nearly the full value of the tax savings. Rarely, however, are these conditions met. Therefore, the tax preferences can be expected to increase the ultimate cost of resolutions.

In an ideal situation, insolvent thrifts would be acquired by those parties who are likely to operate them most efficiently. Yet, rules that facilitate the use of tax-deductible net operating losses and built-in losses could have the unintended effect of awarding the insolvent thrift to the wrong bidder. In particular, the highest bidder may be the one who values the tax consequences of the losses most highly. Thus, the bidding could be dominated by those who expected the greatest tax gain, rather than by those who might operate the thrift most efficiently.

Avoiding Future Losses

The thrift crisis has already been quite costly to the U.S. economy. To say that resolving the thrift crisis will cost \$100 billion is to say that the capital stock of the United States is that much smaller and, as a result, that national incomes both now and in the future will be lower. While my previous discussion has largely involved paying for the loss that has already occurred, great importance should also be attached to creating a regulatory system and a deposit insurance system that prevents future crises from developing. This prevention involves limiting future losses of both currently insolvent thrifts and thrifts that will become insolvent in the future.

The best way to reduce the costs associated with the currently insolvent thrifts is to resolve them quickly. These thrifts would then be unable to make more bad investments or drive up interest rates as they seek to fund their ever-increasing operating losses with ever-increasing deposits. Even with unlimited financial resources, however, administrative constraints and other factors will limit the pace at which insolvent thrifts can be resolved. As part of its suggested solution to the thrift problem, the Administration proposes to monitor the activities of insolvent thrifts that remain open in order to limit their losses.

Because federal deposit insurance reduces the incentive of poorly financed thrifts to behave prudently, it is necessary to change these incentives and to monitor the industry more closely. In fact, the Bush Administration has proposed a significant overhaul of the existing regulatory apparatus. It recommends putting much of the regulatory responsibilities for thrifts in the Department of Treasury and the responsibility for insuring thrift deposits with FSLIC. More fundamentally, the Administration proposes that, in certain critical respects, thrifts be treated more like banks.

Specifically, the Administration recommends requiring that thrifts increase their amount of capital, which is the difference between a firm's assets and its liabilities. Capital is essentially the owners' stake in the firm, and increasing the amount of capital that thrifts must maintain should reduce the likelihood of insolvency. A higher capital standard not only reduces the incentives to make risky investments, but it also provides a cushion for the insurer in case the institution experiences financial difficulty. Accordingly, the Bush Administration proposes that by 1991, thrifts must—as banks do now—maintain capital of not less than 6 percent of their assets.

About one-half of the thrifts that are currently solvent meet the new standard. By the same token, over 1,000 thrifts do not. Many of these institutions will be unable to attract the needed additional capital to meet the new requirement. Enforcing the standard may require a substantial number of liquidations and mergers. Since these institutions are solvent, however, the cost to the government should be largely administrative. In fact, many mergers may occur without government intervention. Moreover, higher capital standards should relieve the widely perceived overcapacity in the industry. With higher capital requirements, firms will have to finance loans with more equity and fewer deposits. As a result, operating margins in the industry should increase and the quality of their assets should improve.

A number of other steps would limit the probability that anything like the current thrift crisis will reoccur. One such step would be to give the government

greater flexibility to take action when a thrift's financial position deteriorates. Encouraging a financial institution to hold a diversified portfolio of assets would also make it less likely that it will become insolvent. Diversity lessens the likelihood that the poor performance of a particular region or industry would erode the financial strength of an institution. Current federal and state policies that discourage expanded geographic coverage are, at least in this respect, counterproductive.

Regulatory reform is very important. Nevertheless, if addressing this issue were to slow the resolution of insolvent thrifts, a comprehensive reform of the regulatory system could impose significant costs. In the first place, because insolvent institutions must continually attract increasing amounts of deposits just to fund their current obligations, they raise the cost for solvent thrifts that must compete with them. This effect makes it more difficult for solvent institutions to raise necessary levels of capital; in fact, it may ultimately force more institutions toward insolvency. Insolvent thrifts also have incentives to make overly risky investments.

In addition, the Bank Board is already taking steps to improve regulation of the industry. For example, it has proposed increasing the industry's capital requirements and is monitoring the behavior of individual thrifts more closely. Therefore, while it is desirable both to resolve existing insolvent thrifts and develop a new regulatory regime, the Congress should be mindful of the extent to which including comprehensive regulatory reform in any plan could delay an ultimate resolution to the current thrift crisis.

CONCLUSION

The cost to the economy of the thrift crisis has already been considerable. The Congress might want to consider a number of steps to reduce any additional costs. One of the most important is to act quickly. The Congress may also be able to speed the resolution by relying on Treasury funding and considering regulatory reform separately from the resolution of insolvent thrifts. It is, nevertheless, critical to reduce both the incentives and ability of thrifts to act imprudently in the future. While the resolution should be funded with government borrowing, a good case can be made that most of these expenditures should not be counted against budget ceilings in the Balanced Budget Act. Finally, with adequate financing to deal with the problem, there seems little reason for continuing the current tax preferences for acquirers of insolvent thrifts.

Chairman ROSTENKOWSKI. Thank you, Mr. Blum.

Mr. Pickle.

Mr. PICKLE. Mr. Blum, you said the best way to reduce the cost of these losses is to liquidate these insolvent S&L's quickly. What do you mean by quickly?

Mr. BLUM. Well, I mean as soon as it is humanly possible. There are administrative constraints that would take time just to work through. As long as the thrifts continue operating, however, they have the incentive to act in an imprudent manner, because their deposits are essentially insured by the Federal Government. They thereby incur greater losses, and in the future the ultimate cost of resolving this problem would grow.

Mr. PICKLE. Well, let us take a practical example. Suppose we close them all down next month, 300 of them. Who is going to pay for that?

Mr. BLUM. Well, the bulk of the money is going to have to come from the taxpayer, mostly. And—

Mr. PICKLE. Either we have got to create another corporation and issue notes against them, so to speak, or we have got to pass a tax bill just giving them the money. It is one or two, is it not?

Do you think that is going to be likely in the terms of the time that you said?

Mr. BLUM. Well, actually, Mr. Pickle, I think you are in a better position to judge how quickly that could happen than I am.

Mr. PICKLE. Let me make it easy. Perhaps I am, although I do not know that I do know what the answer is to the question myself. But I will have to say to you, if you close all these institutions, I do not know how you are going to pay them off and what is going to happen. It is good to say it, but what do you mean by quickly?

Now, under the new proposal, FDIC is supposed to in effect hold these insolvents. You say we ought to close them and that way they cannot make any more bad loans. They are not making any loans now. Whether they are solvent or on a borderline now, they do not have any ability to do anything much now. Because the FDIC or somebody is looking over their shoulders. And they cannot even go get cup of coffee. There are no loans being made in my part of the country, very few.

So when you said you keep these institutions from making continued bad loans, I think we pretty much have got that cut off now because they are not doing anything about it now. I am just saying as a practical matter I do not know how you are going to close them down, as you say, "quickly". It is good to say it.

Now, I will ask another question. You said I am in a better position to answer the question. Do you think the proposal of raising \$50 billion through this REFCORP is a workable plan and should be adopted? Do you have a position on that? You are CBO, you advise us. Now, you tell me what would you do.

Mr. BLUM. Well, the Congressional Budget Office, as you know, does not make policy recommendations to the Congress, but the statement that we prepared for this testimony drew the conclusion that the amount of moneys or resources that the administration is contemplating in its proposal seems to be adequate to do the task as it is now understood.

The heart of a large part of that financing would come through the raising of \$50 billion through this off-budget borrowing, but the ultimate key here is that the proposal also has unlimited resources provided by the Treasury, if needed.

Mr. PICKLE. The issuance of these so-called certificates, bonds, is pretty much the same—would you call them war bonds? Are they the same thing as Treasury bonds? What is the difference?

Mr. BLUM. They would be interpreted by the markets as being very close to Treasury bonds, but there would be a premium charged on them. There would be an added cost to the Government.

Mr. PICKLE. Eventually we could get our money back for the premium, because eventually we could pay off the interest. Because you make this certificate available, we pay the interest on those certificates, those notes. That is where the debt comes to the Treasury, is it not? We have to continue to pay the interest.

Mr. BLUM. That is true.

Mr. PICKLE. Eventually we might get it back at maturity if the obligation goes to maturity. If that did not happen, we could lose it on two fronts. But most of all, we are creating another corporation. And I think that is the biggest question that this committee has.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

I would just like you to go back and comment once again and maybe expand a little bit your comments about the tax provisions, how they have been used, and how they may ultimately exacerbate the problem that exists. Have they been useful in your opinion?

Mr. BLUM. I do not know if I can answer that precisely. It clearly has been useful to FSLIC during the month of December when it worked to resolve many of the insolvent S&L's. And it was useful to FSLIC, as we heard Mr. Wall and the other members of the board testify, because they had an absence or shortage of cash to handle the problem more directly. So in that sense they were useful.

Mr. ANDREWS. Well, I am not asking you to make policy this afternoon, but if a scenario plays out where there is not adequate funding in the feeling of the administration or in the Congress to take care of this problem, will we be back debating the extension of some of these tax provisions?

Mr. BLUM. Well, consideration might be given to it. But I would note that those tax losses—the tax benefits—do show up as reduced revenues directly on the budget eventually. And while they might not be—they might not loom large for any one particular year, they would accumulate over time.

Mr. ANDREWS. You do not have any idea what that revenue number might be today?

Mr. BLUM. Well, the—

Mr. ANDREWS. I mean can you tell that from the December transactions?

Mr. BLUM. The Home Loan Bank Board has put out an estimate that we cited in our staff memorandum of present value calculation of close to \$6 billion. The Joint Tax Committee has prepared a preliminary estimate that would put the cost in present value

terms at about \$7 billion. But we heard this morning also that the General Accounting Office is looking into that matter and will be coming up, hopefully next month, with its own estimate. But that is the order of magnitude that is being discussed.

Mr. ANDREWS. Thank you, Mr. Blum

Chairman ROSTENKOWSKI. Mr. Vander Jagt.

Mr. VANDER JAGT. Thank you, Mr. Chairman.

The estimates that you just gave Congressman Andrews, you were not here when FSLIC was testifying—or were you?

Mr. BLUM. I was here.

Mr. VANDER JAGT. I understood Mr. Wall to say that when you count all the benefits for just what they did in December with the use of the tax benefits, that it was a net gain of \$2.2 billion. Do you have any idea what he is including that you are not including? Why the big disparity? He made a point of saying inclusive of the tax revenue that we are losing it still is a net gain of \$2.2 billion, just what they did in December. Can you just—

Mr. BLUM. I think that there are different ways that this can be looked at. And perhaps the way in which he is—

Mr. VANDER JAGT. I realize it is a little unfair to ask you to explain a figure that I am sure you would not agree with. And I am not sure I do. But I am just trying to get some guidance as to how to approach it.

Mr. BLUM. I think one way of looking at it that probably would be similar to the view of the Home Loan Bank Board is, given the absence of cash resources that FSLIC is facing and the need to move expeditiously to close or resolve these insolvent thrifts, the use of the tax benefits enabled them to come up with a large number of these assisted acquisitions last year. And December was a good case in point.

It may be that they are saying that it was cheaper in the long run, in terms of the ultimate S&L cost, to move quickly at that time, even though from the Government's point of view we may be losing money by use of these tax benefits.

Mr. VANDER JAGT. Correct this oversimplification on my part. You are saying that if we identify direct subsidy or direct payment, whatever you want to call it, it would have been cheaper than using the tax benefits. And what he is saying is that if we had not used the tax benefits and everything else, we would have lost a lot more by the continuing hemorrhaging. And that is how he comes up with a net savings to the overall budget of \$2.2 billion?

Mr. BLUM. I think that is right.

Mr. VANDER JAGT. Thank you.

Chairman ROSTENKOWSKI. Mr. Blum, I want to thank you for your testimony and the fine memorandum that you have prepared for the use in this committee.

Based upon your memorandum, is it your opinion that a proposal to assist troubled thrifts in the most financially efficient manner would require allowing the special tax rules to expire at the end of this year?

Mr. BLUM. I think that from everything that we have looked at, would make the most sense, on the assumption that sufficient financial resources are made available to the FDIC, FSLIC, or what-

ever is the group that is charged with resolving the present problem.

Chairman ROSTENKOWSKI. Well, based on what happened in December, one is lead to believe that the bailout was almost illegal. I am wondering, with respect to the administration's proposal, do you think that providing off-budget bond financing would significantly increase the overall costs of this plan?

Mr. BLUM. Well, there is no question about it, that going an off-budget borrowing route means that you are creating a new kind of financial instrument for the markets. It will have a higher interest cost attached to it. We had—using as an example the FICO bonds, the Financing Corporation bonds that are being used to provide \$10.8 billion in funds for FSLIC, those are now selling at a premium of roughly 70 basis points over comparable Treasury bonds.

I do not know that the cost for this \$50 billion would be as high, but let us say it is on the order of 30 basis points above comparable Treasury borrowing. That works out to \$150 million a year in additional interest costs that the Government is going to have to bear for this borrowing. And over time, that adds up. If you accumulated that for the full 30 years contemplated, then we are talking around \$4 billion.

Chairman ROSTENKOWSKI. Well, Mr. Blum, going off-budget, what does that accomplish? Creating a smaller visible deficit?

Mr. BLUM. That is one of the things that it accomplishes. It keeps the deficit—the measured deficit as reported by the Treasury and OMB—lower. It keeps this problem from adding to the deficit problem for 1990 under the Gramm-Rudman-Hollings Act.

Chairman ROSTENKOWSKI. Exactly. And so, you know, the revenue of approach here is pretty much viewed as to what is the deficit going to be looking like around August or September?

Mr. BLUM. I do not think that there is any question about that, Mr. Chairman, that if we did not have that pressure—Gramm-Rudman-Hollings pressure—right now, the most sensible approach for raising this \$50 billion quickly would be to let Treasury borrow it in the most efficient manner. And that would be the lowest cost ultimately to the taxpayer.

Chairman ROSTENKOWSKI. Well, just 1 minute ago I made the observation that what I want to do is get this grocery list of what it is going to cost us as quickly as possible. You know, there are going to be some egg on some people's cheeks here. But I think the best thing we can do for the American people is let them know just what our problems are and face up to the realities of the moment and try to do something about it.

Now, I do not know how courageous the membership on the floor of the House is going to be or even how courageous we are going to be in this committee, but I think what we really owe the American people is an honest estimate of the situation that we are finding ourselves in. And whether or not, you know, we are playing games here again with the smoke and the mirrors and the off-budget, on-budget accounting, these are bills that are going to have to be paid by us.

Mr. BLUM. I would agree with you completely, Mr. Chairman. We did point out in our memorandum and in the statement, though, that a good case can be made for exempting the spending of this

\$50 billion from the Gramm-Rudman-Hollings deficit calculations. This spending is the flip side of the asset sales that are now not counted under Gramm-Rudman-Hollings as a deficit reduction.

Those asset sales are correctly perceived as not really reducing the deficit. Similarly, this kind of spending is not really having an economic impact in exactly the same meaning. So I think that a case can be made for doing it all on budget where it all can be seen, but not letting it interfere with the fiscal policy embodied in the Gramm-Rudman-Hollings deficit targets.

Chairman ROSTENKOWSKI. Are there any further questions of Mr. Blum?

[No response.]

Chairman ROSTENKOWSKI. If not, thank you very much for joining us. We appreciate it.

Mr. BLUM. My pleasure.

Chairman ROSTENKOWSKI. Mr. Carron, Mr. Maisel, Mr. Kane.

Welcome, gentlemen. We are looking forward to your testimony.

You know the procedure here, Mr. Carron. You will start. And then Mr. Maisel and Mr. Kane. If you would like to begin, Mr. Carron, we are ready to take your testimony. Please identify yourself for the record.

STATEMENT OF ANDREW S. CARRON, DIRECTOR-MORTGAGE RESEARCH, FIRST BOSTON CORP.

Mr. CARRON. Thank you, Mr. Chairman.

My name is Andrew Carron. I am Director-Mortgage Research at the First Boston Corporation in New York.

You have my complete written statement. I will just make a few brief remarks at this time.

Chairman ROSTENKOWSKI. For the purpose of informing these panelists, your entire statement will be included in the record. If you care to summarize, feel free to do so.

Mr. CARRON. The subject we are discussing here today is properly called a bailout, but the money that will be required is for depositors, not depository institutions. Whatever the eventual cost turns out to be, it represents depositors' money that has been lost and which must be replaced.

I do believe that the figure of \$100 billion is a reasonable estimate for purposes of developing a plan to resolve the crisis. And the balance of my comments will operate on that assumption.

I think it is instructive to review exactly where the \$100 billion went. Although some part of it undoubtedly went into the pockets of dishonest or unethical operators, the bulk of the amount went elsewhere.

Home buyers who took out low interest rate mortgages in the sixties and seventies reaped a windfall when market rates of interest rose to 15 percent and higher in the early eighties. They were paying 6 to 9 percent on their loans and earning 15 percent on their savings. This spread translated into large operating losses at S&L's.

My estimates at the time were that the cost to liquidate the thrift industry when interest rates peaked in 1982 would have been about \$90 billion. The Joint Committee staff report for this hearing

quite properly notes that traditional accounting methods failed to disclose this loss. This embedded loss was substantially reduced by the fortuitous decline in interest rates in late 1982 and 1983.

In hindsight, that would have been the ideal the time to step in and reorganize the thrift industry.

A second component of the \$100 billion loss derives from money lent to individuals to buy property at the peak of the market. When property values declined, many of those loans went bad. Property owners who sold out at the peak of the market in Texas and elsewhere took home some of that \$100 billion.

As we all know, the problem grows worse by the day. What is the source of this continuing depletion of funds? There are many offices and employees in the thrift industry that are not fully and efficiently utilized. This lack of productivity creates further losses.

Finally, one observes the very high rates of interest paid to depositors at weak and insolvent thrifts as compensation for the uncertainty surrounding deposit insurance and the thrift bailout. This too is a contributing factor.

To summarize then, much more of the \$100 billion loss represents interest paid to depositors, wages and salaries paid to employees, and capital gains on property sales than can be attributed to fraud and abuse. Now, I do not say this to justify the use of taxpayer funds for the bailout, but rather to show that it is unreasonable to expect that we could recoup more than a small fraction of the \$100 billion from its recipients.

Initially one should attempt to recover as much as possible from the assets of failed thrifts. I think there is very little disagreement about that.

Next, deposit insurance premiums should be equalized for banks and thrifts. But I do not think the overall level of premiums for thrifts should be materially increased. To do so would worsen the competitive inequality between thrifts and banks, thereby exacerbating the situation. A very large share of the assessments is already being paid by insolvent or marginally capitalized thrifts.

Some have suggested looking at the federally related agencies such as the Federal Home Loan Bank System. There seems to be a consensus that the retained earnings of the System can be drawn upon to address the thrift problem. I would caution that excessive reliance on the capital of the Bank System, or other agencies, could upset the capital markets and restrict the supply of funds for housing without any meaningful reduction in the cost of the bailout.

That leaves public funds as the final source of resources, and the only one large enough to finance the bailout. The plans to raise a substantial amount of money through bond financing to be paid out over a number of years is a good idea because it permits a more rapid resolution of the problem.

This committee and the other committees of Congress will need to consider, however, whether a new bond issuing agency represents the least cost method of obtaining the requisite funds. Direct Treasury issuance would be less costly but would require potentially time consuming discussion over the Federal budget deficit and the long-term debt ceiling.

Despite the anticipated restructuring of the thrift industry and its regulatory structure, U.S. housing policy will not be disadvan-

taged. Thrifts will continue to play a major role in the provision of housing finance.

It is now appropriate to consider equalizing the regulatory and tax treatment of thrifts and banks to permit the thrift industry to adapt and compete in the current economic and financial environment.

The new asset powers that were granted to the thrift industry in the early 1980's did not directly cause the problems we have today. To be sure, wider investment powers made it easier to take risks, more costly to resolve problems, and more difficult to detect incipient difficulties. But proper examination and supervision would have avoided these problems. The real failing of regulation was the unwillingness and ability of regulators to intervene before the market value of the financial institution reaches zero.

Other reforms, such as change to the deposit insurance system, may be useful but a strict closure rule is the most important.

Thank you.

[The statement of Andrew S. Carron follows:]

Statement of

Andrew S. Carron
 Director - Mortgage Research
 First Boston Corporation
 New York

before the

Committee on Ways and Means
 U. S. House of Representatives

February 22, 1989

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to testify on the current condition of the savings and loan industry. I have studied the industry extensively since 1980, when I was a senior staff member in the economic studies program of the Brookings Institution. I am currently manager of the mortgage research department of the First Boston Corporation, where my current responsibilities include evaluating the impact of the savings and loan situation on the secondary mortgage market, advising thrift institutions on asset-liability management, and analyzing investment opportunities.

At the Committee's request, I am appearing today as an industry expert. I will express my personal views only as I am not appearing on behalf of First Boston.

My comments will be in two parts, corresponding to two of the topics on which the Committee has requested testimony: The magnitude of the financial difficulties of the savings and loan industry and the costs, structure and appropriateness of any potential Federal assistance; and, the budget and policy implications of the financial difficulties of the savings and loan industry.

Magnitude of the Problem: Federal Assistance

It is my opinion that:

1. The largest share of the costs should be paid out of general revenues.
2. Deposit insurance premiums should be equalized for banks and thrifts.
3. Specific taxes on the thrift industry would be counterproductive and should be avoided.
4. Involving government sponsored enterprises in the thrift industry recapitalization would yield a relatively small amount of resources, but would reduce efficiency and raise costs in housing finance generally, and should therefore be avoided.

No single cause was responsible for the reduced earnings and widespread failures of thrifts during the 1980s. The relative contributions of the various factors are difficult to distinguish, and may vary substantially from case to case. There are two parts to this issue.

First, why did large numbers of thrifts lose money and ultimately fail? This is a legitimate matter of concern for the individual institutions involved and for the thrift industry as a whole.

Second, why have these thrift losses and failures imposed high direct and indirect costs on healthy thrifts, government agencies, the banking system, and the economy? I believe this issue should be the focus of public sector involvement.

The failures could have occurred without imposing a burden on other firms or sectors of the economy. The crisis has so far spawned substantial indirect costs and the likely prospect of a large direct cost. Failing thrifts have bid up deposit costs and impaired the health of solvent banks and thrifts. FSLIC insurance premiums were raised 150 percent. That the thrifts' problems did create spillover effects should be the main concern for public policy. Such costs raise interest rates, reduce investment, and therefore impair future economic growth.

Individual thrift institutions may have contributed to their own demise, but were not responsible for the growth of the FSLIC's liabilities beyond its resources. Contributing causes to the public crisis were the depletion of the industry's net worth in the early 1980s, the existence of federal deposit insurance, inadequate examination and supervision, and a lack of coordination between state and federal authorities. Most important, however, was the federal regulators' inability or unwillingness to close institutions prior to insolvency.

To the extent possible, the government should seek restitution from those thrift owners responsible for the risk-taking and the costly failures. There were also failings in the regulatory process, so part of the cost rightly should be paid by the government. These government liabilities have been incurred over the past decade, and thus should not be considered "new" expenditures.

Furthermore, as a practical matter, there will have to be federal contributions, regardless of whether the ultimate cost turns out to be \$50 billion or \$100 billion or more. While depository institutions derive substantial benefits from the deposit insurance system, additional insurance premiums on the thrift industry might be counterproductive. The current disparity between bank and thrift premiums represents a serious competitive inequity, and this should be addressed. But higher premiums overall, even if levied equally on banks and thrifts, might raise the incidence and cost of financial institution failures by raising operating expenses and by encouraging disintermediation.

Seeking additional resources through the Financing Corporation or the Federal Home Loan Bank System, without Congress providing the agency with additional funds or credit support, would similarly be inappropriate. To do so would depress the value of outstanding agency debt and raise financing costs, which ultimately are paid by the thrift industry. The repercussions in the capital markets could have a deleterious effect on the cost of housing finance to homebuyers.

Budget and Policy Implications

It is my opinion that:

1. Regardless of the form that federal assistance takes, there will be a large budget impact. Legislation to resolve the thrift crisis should seek the least-cost methods for doing so.
2. Despite the restructuring that will take place, U.S. housing policy will not be compromised. Thrifts will continue to play a major role in the provision of housing finance.
3. Over the long term, thrifts cannot be viable if compelled to hold home mortgage loans as their principal assets, because developments in the secondary market have lowered most mortgage rates below thrifts' costs. Taxation and regulation of thrifts should be rationalized to permit, but not require, thrifts to invest in home mortgage loans.

Hundreds of thrifts will ultimately require assistance to protect depositors. The cost may be as high as \$100 billion, and the total is growing by roughly \$1 billion per month.

Today's thrift crisis is, to a considerable degree, the accounting recognition of past economic problems. Real estate losses in the Southwest, for example, reflect overconstruction stimulated by the energy boom of several years ago. The oil price collapse in 1986 directly slowed economic growth through a 40 percent cutback in real investment in the domestic energy industry, adding to the difficulties of local real estate markets. The result is solvency problems at Texas banks and thrifts.

Although the thrift crisis reflects the past, how it is managed could affect future economic performance. The thrift crisis is essentially fiscal -- how can the federal government raise, through taxes or borrowings, upwards of \$50 billion to meet the FSLIC's unfunded obligation to depositors?

The administration's proposal puts some of these expenditures outside the scope of the budget for the next several years. Also, the industry itself is being asked to take on a share of the burden. Nevertheless, there will be a large budget impact now and for years to come as the Treasury is called upon to fund the annual interest payments on the proposed Resolution Funding Corporation bonds.

An important part of the administration's proposal involves the consolidation of bank and thrift regulatory agencies and the homogenization of bank and thrift regulatory requirements. This raises the question of whether the thrifts' traditional role in the provision of housing finance will be impaired. More broadly, should the existing distinctions between banks and thrifts that exist in tax law and elsewhere be removed, and what impact would that have on housing. This important issue must be put in context.

Thrift institutions engage in a variety of mortgage-related activities. They originate and service whole loans, and they trade and hold both whole loans and mortgage related securities. Mortgage-related revenues come from origination and servicing fees, coupon interest, gains on sales, and miscellaneous sources such as prepayment penalties and escrow accounts. The legal definition of a thrift, however, is quite narrow: an institution that, once chartered as a savings institution, holds a specified percentage of total assets in mortgages and/or mortgage-backed securities.

Of course, if these regulations were removed, there would be little substantive distinction between thrifts and banks. That event, some would say, is tantamount to abolishing the thrift industry and would result in flooding of the market with the \$1 trillion in mortgages held in thrift portfolios. However, the thrift industry, as a statutory definition, must be distinguished from the 3,300 individual thrift institutions that comprise it. The firms themselves, and their mortgage assets, would remain intact if their industry definition were changed. Many, if not most, would choose to continue their specialization in mortgage-related activities, but it would be specialization by choice rather than by regulation.

Substantial diversification away from mortgages has already taken place. Among the many activities engaged in by thrifts, traditional single-family mortgage lending (portfolio investment) is the only activity to have a clear decline since the beginning of the 1980s. Mortgage banking activity has increased, as evidenced by an increase in the ratio of loans serviced to loans held from 34 in 1980 to 24 in 1988. Some thrifts have shifted their asset mix away from mortgage loans toward investment securities (other than mortgage-backed securities). Such assets have contributed a greater share of income in recent years. The share of assets devoted to real estate development has increased nearly 50 percent since 1980. Thrifts are also beginning to offer a full range of nonmortgage loans, paralleling the services provided by commercial banks. The share of nonmortgage loan assets has increased substantially, as the revenue share from those sources has doubled.

In recent years, mortgage lending has been intermittently profitable for thrift institutions. Traditionally, thrifts funded higher yielding long-term mortgage assets with lower yielding short-term funds, paying expenses and a return on capital with the yield spread. Despite a recent narrowing of the maturity gap between assets and liabilities, the effective duration of thrift assets is still longer than that of thrift liabilities. Thrifts earn a positive spread from portfolio loans when interest rates decline or remain stable. When interest rates rise sharply, the typical thrift loses money. So thrift performance, even in recent years, is largely dependent on whether interest rates have risen or fallen. Historical performance measures are therefore not a good indication of the profitability of portfolio lending in general.

In recent years, thrifts could expect barely to break even on their investment in mortgages. It is not a paradox, however, to say that the mortgage lending business, viewed in its entirety, may be profitable. Mortgage lending entails many steps, of which holding the pure loan in portfolio is only one. Thrifts have profited from the non-investment aspects of the mortgage business.

The development of a secondary mortgage market and a variety of mortgage-related securities has removed many of the obstacles faced by investors who wished to invest in mortgages. Thrifts no longer have a comparative advantage in holding "unfamiliar" and "illiquid" long-term amortizing mortgages, and may even be at a disadvantage because of their portfolio restrictions. But mortgage securities have not greatly affected the other attributes of mortgages, and it is in these areas that thrifts continue to excel.

Thriffs have profited from mortgages as the result of unexpectedly favorable interest rate moves, superior underwriting abilities, efficiencies in loan servicing, fees collected for loan origination, and intermediation between more and less liquid instruments. They may also have benefited from below-market liability costs, marketing and cross-selling advantages, and imperfect consumer information. Of course, none of these profits require the mortgage loan to be held in the thrift originator's own portfolio.

Under current conditions, the thrift industry will never attain consistent profitability, a fair return on invested capital, and a stable role in the provision of housing finance. If nothing is done, the industry will decline and impose further costs on the deposit insurance system.

The only viable solution for the future is removing the requirement that thriffs hold 60 percent of their total assets in housing related instruments. Changes to tax law, relating to the percentage-of-income bad debt deduction, would be needed to gain all of the benefits of such a change in regulations. Thriffs need the flexibility to adjust their portfolios in response to changing market conditions. They would likely continue to be active participants in the origination and servicing of loans. Even if the share of mortgages in their portfolios were to decline, the impetus for growth and investment in thriffs would likely increase the aggregate mortgage holdings of the industry. Coordination or consolidation of bank and thrift regulation is a necessary component of this approach, as thriffs come to be identified more by the functions they perform than by the charter they hold.

Chairman ROSTENKOWSKI. Mr. Maisel.

**STATEMENT OF SHERMAN J. MAISEL, SCHOOL OF BUSINESS
ADMINISTRATION, UNIVERSITY OF CALIFORNIA, BERKELEY**

Mr. MAISEL. Thank you, Mr. Chairman

My name is Sherman Maisel. I am with the University of California, Berkeley.

I shall summarize the main points of my statement briefly.

It is critical that action be taken now to assure the Federal financing needed to allow the orderly liquidation of the insolvent and nonviable thrifts. Equally important is the adoption of a sound plan and structure for the future. Several potential pitfalls that threaten to raise costs and waste more of the taxpayers' money need to be avoided.

I agree with several of those who spoke earlier, you ought not to allow the use of tax expenditures to entice minor amounts of new capital into the restructuring of failed firms. The tax subsidies raise the total cost to the Government. The economy ends up with expensive but weak firms.

The cost of using off-budget borrowing, such as through the Resolution Funding Corporation, in an attempt to fudge the costs to the Government will raise the real costs. Losses have already occurred. Should they not be recognized and taken as part of this year's deficit?

As I understand the current proposals, they would improve the deficit picture for 3 years only to make them worse in the future.

Liquidation should proceed at an orderly rate. What is needed is a coherent national policy as to what assets to sell, when to sell them, and when to hold them. It is difficult accurately to value and market real property. If the insolvent thrifts are restricted from making new loans, letting them pare down over time may be more cost effective than turning their assets over to a liquidator.

The estimates that say that keeping them open costs \$½ to \$1 billion a month more than the cost of closing them are almost certainly wrong.

Just as wrong would be keeping open, except in a liquidation mode, marginal firms without adequate capital. Allowing undercapitalized firms to make loans and purchase risky assets is at the bottom of the current mess. There is no magic in the current number of firms. If the number of firms in the nation per capita followed the California pattern, only about one third of them would be needed. Yet California is a very competitive market.

What should the future look like? Contrary to the frequently expressed view, I believe that a logical role exists for specialized home lending and consumer institutions. Future homeowners will be penalized if this source of portfolio lending, particularly on variable rate mortgages, is closed down. In tight credit markets, over-the-counter borrowers cannot compete. National saving and investment is enhanced by institutions that channel some new money and credit into the residential market. Consumers have profited from higher deposit rates and better service by having a unique set of consumer institutions.

Deposit insurance rates should be raised across the board to take as much of the burden as possible from the general taxpayer. Past rates have been too low. The users of financial services should make up for past shortfalls to the extent possible. Provided that rates move together for all firms, no firm will suffer.

The two insurance funds, FDIC and FSLIC, should be merged. This will reduce the amount of capital to be raised. Even with a single insurer, specialized thrifts can be maintained by use of the Home Loan Bank's existing tax benefits and regulations. If they are risk-related, common capital requirements will still permit thrifts to operate with lower but adequate capital since home mortgages carry a much lower risk.

A final word as to what caused past losses and therefore what must be avoided in the future.

Losses are primarily the result of allowing firms to operate with inadequate capital. They took large risk using the Government's deposit insurance funds as a guarantor with little of their own money at risk. It was a heads-I win, tails you lose proposition. All profits were reaped by the owners while the Government absorbed all the losses.

For a study for the national science foundation 11 years ago, a group of economists of which I was one, warned against this in several books and articles. Now is the time to make certain that we do not take similar risks at the Government's expense in the future.

Thank you, Mr. Chairman.

[The statement of Sherman J. Maisel follows:]

Testimony of Sherman J. Maisel
School of Business Administration
University of California, Berkeley

before the U. S. House of Representatives
Committee on Ways and Means
February 22, 1989

Mr. Chairman and Members of the Committee:

It is a pleasure to be able to discuss with you problems in cleaning up the savings and loan situation, together with its tax and budget implications.

Most critical is the assurance of federal financing to allow for the orderly liquidation of the insolvent and non-viable thrifts, together with the adoption of a sound plan for the future. Large sums have already been wasted in attempts to avoid facing up to this problem. If we lose this opportunity to rationalize the industry, even larger sums will be lost in times to come.

President Bush's proposals are a good starting point for Congressional consideration. However, many details must be worked out. Among the most important are decisions as to what the future thrift industry--if one is to exist--should look like, which of past mistakes can be avoided, and who should pay for the losses that already exist.

I believe that:

--- We should attempt to maintain a separate thrift industry, with its firms primarily limited to lending on homes and other consumer needs similar to traditional savings banks. A critical mistake leading to the huge losses was allowing thrifts to enter into joint ventures and to make commercial and development loans for purposes unrelated to residential structures.

--- The thrift industry should be restricted to adequately capitalized firms. Money spent to keep insolvent or marginally solvent firms open beyond the time required to liquidate them most efficiently will be wasted. Depositors, borrowers, and taxpayers will all suffer if excess capacity is retained.

--- The current problems arose primarily because of (1) inadequate capital requirements, (2) deregulation, allowing firms to make loans about which they had inadequate knowledge and experience, and (3) a lack of control over firms' rate of growth, capital, and risks. Most losses were caused by ignorant, greedy speculation.

--- It will be costly to delay dealing with the problem. So will the use of off-budget techniques, such as tax expenditures or unconventional financing. While most economic losses occurred when the loans went bad, they have been magnified by a lack of funds to close firms down and to liquidate them in a logical manner. It would be best if losses for the remaining insolvent firms could be shown as a charge against this year's budget.

--- Clearly, costs will be high because of past failures to charge enough for the insurance to cover the risks. Ideally, most of the funds needed to pay for the deficits in FSLIC funds should come from the institutions, depositors, and borrowers who did not pay adequately for the insurance in the past. This argues for an increase in deposit insurance rates, augmented perhaps by a return to prior higher reserve requirements. Since funds from these sources will be inadequate to cover all losses, taxpayers will have to share the burden. Still, a primary aim should be to have users of financial services pay as much as possible and taxpayers the least.

Adequate Funds for a Sound Liquidation and Future Operations

The key need at the moment is for sensible legislation that will allow the consequences of past errors to be dealt with while insuring efficient future operations. This means both finding adequate funds to liquidate insolvent and marginal firms efficiently and, more important, devising a regulatory structure that will guard against a replay of past errors.

The reason that action is needed is not, as some have argued, because the costs of delay run at one-half to one billion dollars a month. Closing down the insolvent institutions now is not going to save anywhere near these amounts. Most of the so-called operating losses are merely the costs of carrying non-earning or barely-earning assets. Whether or not past actions that caused lost values are entered on the books of institutions and the insurance fund, interest must be paid to cover the gap between liabilities and assets. In the same way, interest will have to be paid by the receiver when firms whose liabilities far exceed their real assets are taken over. A saving occurs only to the extent that the government borrows at lower rates than the insolvent institutions. If the government borrows off-budget and for 30 years, instead of the Treasury's borrowing along the full yield curve, rates for the new corporation--and, therefore, the government's costs--will probably be higher than they are now.

A failure to liquidate raises real costs because it retains excess capacity in the industry. Equally important monies are lost because of the difficulty of controlling lending policies of insolvent institutions continuing to operate with old management and stockholders. Without any capital at risk, it pays them to make speculative loans. The need is to wind down these firms now. They should not be authorized to make new loans.

Perhaps more important is the lack of a national policy as to what assets to sell, when to sell them, and when to hold them. Just as we have had a fire sale of institutions, a danger exists that the receivers will take too narrow a view of their market impact and will liquidate too rapidly. Liquidation should be gradual, taking into account the difficulty of accurately valuing real property and the need to market it cautiously, without too rapid an increase in the supply.

The Industry Structure for the Future

Liquidation without a sound future structure for financial institutions, the insurance funds, and the regulatory agencies will invite similar errors and losses down the road.

Doing Away with Thrifts. There is some validity to the arguments of those who say that it would be a mistake to try to maintain a separate thrift industry but that, instead, all sound survivors should be allowed to become commercial banks. They point out that since savings and loans are only part of the mortgage market, interest rates and terms are set at the market price needed to attract other lenders to mortgages. Savings and loans merely meet the prices of these others; they need not and do not offer lower terms. In fact, in most markets, S & Ls charge more than mortgage bankers. They believe that most federal aid has gone either into wasted excess capacity or higher profits. Neither borrowers nor depositors have gained.

The critics say that the government would never have appropriated the 80 or 90 billions of dollars--now being requested--as subsidies to the industry, and that the amount lost far exceeds the public gain from having separate thrifts. Yet past policies committed these amounts through back-door financing. Wouldn't it be better policy to decide how much aid should go to housing and to appropriate it directly, rather than trying to use indirect methods with unknown and unmeasurable results?

Finally, they claim that the current crisis resulted from the fact that the past structure was illogical. Combining regulation and promotion in one industry subject to extreme political pressure was never sensible.

Maintaining the Thrifts. While these arguments are strong, I believe that good reasons exist for maintaining a separate thrift industry--provided that it has a clear mission and that it meets the test of good management and adequate return on capital. However, if savings banks are to have most of the powers and act like commercial banks, a separate industry is not logical. What Congress has wanted in the past, and what makes sense, are institutions specializing in residential lending together with other minor consumer functions.

Why do home and consumer financing banks make sense? While residential financing agencies such as GNMA, the FHLMC, and FNMA and the growth of the secondary market have greatly improved lending on housing, holes in the market remain. A need exists for major portfolio lenders who primarily make variable-rate residential mortgages. Thrifts are the primary force in this critical market.

Thrifts serve to channel a share of newly created money and credit into the housing market. As a result, national savings and investment are higher. Most recognize that the level of saving and investment is too low. Removing institutions that specialize in saving and mortgages might reduce it still further.

The market for insured savings will remain more competitive if specialized thrifts continue. They have paid slightly higher deposit rates in the past and can continue to do so. Parenthetically, I believe that the suggestions made by some in the Administration that removing or reducing deposit insurance would improve operations is wrong. We know from experience that insiders, auditors, and regulators have great difficulty in measuring inadequate capital or insolvency. The chances that this function could be performed by the average depositor are slight. We would return to deposit runs and much greater instability.

An Industry Equipped to Meet National Goals

New legislation should aim at maintaining only those financial institutions that are efficient, whose capital is fully adequate to absorb lending risks, and that can give their customers the highest deposit rates and charge the lowest mortgage interest. Since capital requirements should be--and, hopefully, are to be--related to risk, thrift institutions specializing in residential mortgages would not need as much capital as those institutions making commercial loans and having large off-balance-sheet commitments.

Some observers have expressed concern because marginal firms with inadequate capital may have to leave the industry. Such departures should be welcomed. If a firm cannot raise adequate capital to handle its risks, it should not be open. Some of the biggest errors of the past were to reduce capital requirements and allow special regulatory accounting. Even general accounting procedures for financial institutions have been inadequate because they do not require the recognition of losses caused by changes in market interest rates and collateral values. The use of regulatory accounting compounded the problems.

Major costs to borrowers, depositors, and taxpayers resulted from excess capacity that developed because firms were not required to have capital sufficient to cover their risks. They were subsidized by the insurance fund. The elimination of non-viable firms will be helpful, not harmful, to the economy. If they are not efficient enough to survive, they are being subsidized either by their customers or by the government, and neither makes sense. If they are closed as soon as they become insolvent, their closing will not increase the government's losses.

If only efficient firms remained, there might be far fewer than the current number, but the public would be better off. There is no magic in large numbers of institutions. If a pattern of financial institutions equivalent to that which now exists in California were adopted by the country as a whole, we would have less than 5,000 banks and thrifts rather than over 16,000. Most would agree that California has more than enough institutions to assure competition and good service. Efforts to keep existing insolvent and marginal firms open, even with new management, are costly.

Except for requiring thrifts to pay part of the costs arising from past errors in the industry, it does not seem logical to keep two separate funds under one management. Costs and the amount of reserves required, as well as deposit interest rates, would be reduced if the FDIC and FSLIC funds were merged. The FDIC now insures some savings banks and other thrift institutions. Maintaining separate housing and consumer institutions depends on capital, lending, and tax regulations, not separate insurance funds.

What Went Wrong?

Past errors contain valuable lessons as to what not to do in the future. What did go wrong? Only a small share of the losses are due to fraud and high living. Most arose from mismanagement, taking of excess risks, ignorance, and poor regulation.

The losses developed because the country has buildings without tenants, half-finished projects, and the after-effects of a speculative credit bubble that inflated land and building prices. Results were similar to those following the Florida Land Boom and the South Sea Bubble.

The ability to lose so much money was made possible by deregulation between 1980 and 1983 at both federal and state levels. Particularly at fault was the attempt to keep alive failing institutions with little or no capital through actions of the regulators and the Depository Institutions Act of 1982. In effect, the government assumed all the risks for hundreds of insolvent institutions. It was like staking poker players with piles of chips while allowing them to keep any winnings, even as the government agreed to pay all the losses.

With the ability to get all the funds they wanted through money desks or brokered deposits, S & Ls expanded too fast. Neither they nor the regulators had adequate staffs. Neither realized how many risks were being taken. All the new credit, together with large tax benefits, greatly inflated land and building prices. When inflation subsided and interest rates rose, the inflated values were squeezed out. Regional problems exacerbated some of the difficulties, but these were far less significant than the fact that capital was inadequate for the risks assumed.

How Should the Losses be Paid For?

We must recognize that the FSLIC losses have already occurred. The time at which they are entered on FSLIC's books and are included in the government deficit is a matter of bookkeeping. Whether or not they are recorded, interest has to be paid on the amount by which FSLIC's actual liabilities exceed the depreciated assets. The Executive and Congress must ask how much, if at all, the government's real costs should be raised in order to postpone the budgetary reckoning. The costs have already been inflated because FSLIC did not have the funds to liquidate its problems. To what extent should they be increased now?

The ruling decision as to when to close or sell institutions should be based on the least cost to the government. This rule was not followed last year. In selling off major institutions, FSLIC considered only the expenditure of the insurance fund. It failed to take into account the costs to the government through the tax expenditures used to entice the purchasers.

Such tax expenditures are high. In some cases, savings in taxes will surpass the new capital invested. Buyers were again handed free chips to gamble with the government's money. In other cases, however, buyers received only minor tax benefits. This, of course, is the problem with using tax forgiveness as a policy. How much the government pays depends on the tax position and bracket of those given the benefit. By giving a premium to those with the largest potential tax benefit, such policies run counter to tax reform.

These deals had the additional disadvantage of failing to remove excess capacity. Instead, they restructured weak and under-capitalized institutions. What we need now is to recognize the potential expense of such temporary fixes. The use of further tax expenditures should be avoided. So should non-treasury borrowing or funding primarily with long-term bonds. These techniques also are almost certain to raise total costs.

Paving the Piper

Another critical issue is how to divide the costs engendered by the losses among users of financial services, financial institutions, and taxpayers in general.

I would prefer that most of the funds be raised through increased deposit insurance rates, since these were too low in the past. We should recognize that most of the sums collected will be paid for by the users of financial services--those who benefit from the insurance.

Provided that increased insurance rates apply to all deposit institutions, only a small share of any increased collections will be paid by the firms in the industry. They act primarily as collectors. No one knows better than the members of this committee how difficult it is to trace the true incidence of any charge. However, it is clear in economic theory that the charges will be passed on to the users of financial services. Furthermore, the deposit market is sufficiently differentiated so that they will be passed on rapidly.

The differential to be paid by institutions should be maintained, but gradually eliminated over time. The situation is analogous to taxes. The differentials have already been built into the capital structure. Removing them results in a windfall gain. On the other hand, firms willing to make a single advance payment to the insurance fund to move from a higher to a lower annual rate should be allowed to do so. Even if separate regulatory systems are maintained, firms should be permitted to transfer any time they want, provided that they pay their fair share of the costs that have been accumulated in the past.

I believe also that Congress and the Administration should consider carefully the time at which the losses are recognized for budgetary purposes. It is clear that the losses have already occurred. Their economic consequences were inflated asset values and large unrecorded liabilities of FSLIC, which the Treasury guaranteed through actions of the Executive and Congress.

The federal deficits for the past eight years have been understated. If such losses were discovered in a private firm, it would restate its past revenues and expenses. While I recognize the problems raised by arcane federal budgetary procedures, it seems logical to attempt to recognize the existing losses now. Why should the recognition be limited to the \$12 billion or so proposed in the budget? Couldn't the money be appropriated to pay off the difference between the real asset values and the amounts owed depositors in the remaining 200 to 300 institutions that are insolvent? Wouldn't we be better off making the 1989 deficit reflect actuality rather than expending time, energy, and real costs in an effort to fudge future deficits?

The increased collections from deposit insurance could be used to pay the obligations FSLIC has already entered into plus paying the Treasury for some of the interest on newly issued bonds. Any difference between the new book values for assets held by the receiver and liquidation receipts could also be used to reduce the debt.

In conclusion, we should reemphasize the need to arrive at logical procedures for the future. The mess we are in makes clear the need for a more rational structure for the financial services industry. Attempts to retain insolvent or marginally solvent institutions are likely to add to our previous losses. So will efforts to use tax expenditures or other off-budget procedures to reduce the reported budgetary costs.

Chairman ROSTENKOWSKI. Mr. Kane.

STATEMENT OF EDWARD J. KANE, REESE PROFESSOR OF BANKING AND MONETARY ECONOMICS, OHIO STATE UNIVERSITY, COLUMBUS, OHIO

Mr. KANE. Thank you, Mr. Chairman.

I am a professor of economics and finance at Ohio State University, a visiting professor at Arizona State University, and a member of the Shadow Financial Regulatory Committee.

I appreciate this opportunity to share with you my views on the budget implications of what I call the FSLIC mess. And I will read a very compressed version of my statement.

FSLIC's problems have been brewing for more than a decade. Federal regulators and their oversight congressional Banking Committees were long ago warned of the dangers of letting decapitalized zombie thrifts borrow money and invest it under the blessing that Federal guarantees give to their debt because, of course, this blessing cuts the link between the riskiness of their assets and their capacity to raise funds.

Zombie firms are attracted to high-stakes go-for-broke forms of risk taking than an average promise to victimize FSLIC and Federal taxpayers who back up FSLIC.

However, until very recently rather than taking the proverbial ounce of protection by corralling these zombie institutions, Federal officials pursued a short-sighted strategy of covering up the degree of insolvency and delaying action.

Until this year authorities at the GAO and at the Federal Home Loan Bank Board have systematically understated the depth and breadth of thrift industry problems. Concealing individual zombies' insolvencies permits these firms to issue more deposits and to collateralize other forms of debt. Not resolving the zombies' insolvency encourages its managers to take deep risks with the funds they attract. They suggest that authorities should view this gambler-inspired doubling-up strategy as merely trying to grow out of their problems.

Deferring resolution of thrift insolvencies allows authorities to shift recognition of FSLIC's losses to someone else's watch. Now it turns out to be your watch. For taxpayers and the insurance funds, this procrastination increases in the long run the size and range of the industry's financial wounds as well as the eventual bill for running them through what we might think of as the FDIC/FSLIC "emergency treatment center".

The question is not only how large the treatment-center bill has become, but how and when it came to be so large. It is not enough for Congress to set up a sensible financing plan for paying off FSLIC's accumulated bill. It must also build a system of controls on future back door spending by the deposit insurance bureaucracy that is strong enough to make it reasonably sure that taxpayers will not be asked to confront such a bill again.

In a currently popular song, a singer implores her listeners to "shove me in the shallow waters before I get too deep." Taxpayers' immediate problem is a matter of minimizing FSLIC's bills by get-

ting zombie and potential zombie firms repaired or off the street and doing this at minimum total cost to the Federal taxpayers.

FSLIC's unpaid bill is simply the capitalized value of the future net cost that supporting its guarantees and other obligations imposes on Federal insurance funds and on the Federal taxpayer. To understand this bill and to pay it efficiently, Congress must ask the FSLIC's new FDIC-FSLIC management team to prepare an itemized invoice that breaks down these costs institution by institution.

The capitalized value of these net costs represents the taxpayers' equity stake in each FSLIC thrift. The collection of these stakes deserves to be micro-managed as if it were a portfolio of financial claims formally convertible into common stock. Decisions about which firms regulators should close or restructure and in what order must be designed to bring the growth of the Government's unwanted equity stakes in the stressed thrifts under control and to see that they are reprivatized without waste or corruption.

The Bush initiative focuses on paying the largest part of FSLIC's unpaid bill by taking over the worst several hundred of the Nation's roughly 750 zombies. But the plan is silent on the need to establish accountability for the insolvency resolution process. Objective procedures must be developed and promulgated to establish: first how firms would be targeted for takeover, liquidation, or merger; second, how such actions are to be ordered in time; and third, how to be sure that healthy deposit institutions and other taxpayers get full value for the funds they supply.

In the absence of an adequate accountability mechanism, prospects for arbitrariness, waste, and corruption are terrifying. Establishing accountability is important because insurers and Congress' lack of accountability explains decisions made in the past to reduce effective capital requirements for FSLIC thrifts and to forebear from taking over individual zombie thrifts when they became decapitalized.

This lack of accountability is the crucial defect in public policy that allowed the FSLIC bill to become so large. To make sure the solvency decisions are objective and economically based, authorities and industry leaders must adopt a more appropriate concept of legal insolvency. The criteria developed must focus on the market value of each client's enterprise-contributed capital. We cannot let the test focus on traditional accounting measures of a firm's net worth because this value is favorably impacted by Federal guarantees and because existing accounting rules lead firms and regulators considerable opportunity to self-interestedly conceal evidence of de facto insolvency.

FSLIC officials could easily attract their developing risk exposure in troubled firms. My testimony contains a table that calculates timely projections of FSLIC's exposure in those firms' generally accept accounting principles show to have already exhausted their enterprise contributed net worth.

Had Congress imposed an accountability for such projections as part of the Garn-St Germaine act in 1982, it and FSLIC officials would have been forced to confront FSLIC's deteriorating situation in 1983 and to see it as a consequence of the economically inappropriate capital forbearance policies being adopted at this time.

The February 1989 Bush initiative has three principal elements. One is a proposed sizing of the cost of resolving the insolvencies among FSLIC thrifts. Second is a financial mechanism for funding this cost from increased explicit deposit insurance premiums for thrifts and banks and from general tax revenues. The third is a bureaucratic restructuring of the responsibility for resolving thrift insolvencies and for operating the controls used to discipline future risk taking by thrift institutions.

By explicitly funding most of the Treasury's implicit obligation for current zombies, the Bush initiative greatly improves on previous policies. However, in sizing the problem at \$90 billion, the administration has chosen not to reserve, as a private guarantor would, for FSLIC's anticipated loss exposure in hundreds of distressed and strained thrifts whose economic capital is either slightly under water or slightly positive. In recent months, an upward trend in market interest rates has added to the weakness of such firms. Leaving this perhaps \$45 billion liability unfunded puts an unreasonably large bet on the efficiency of the FDIC's bureaucratic takeover of FSLIC's insolvency-resolution and loss-prevention responsibilities. The plan disingenuously presumes that the FDIC can readily do two very difficult things: First, accomplish the amazing task of raising weak thrifts' capital to 6 percent of assets by June 1991; and, second, rely on a tougher cease-and-desist powers and criminal and civil penalties to restrain future abuse of the deposit insurance guarantees.

The plan's faith in the FDIC to carry this burden is its most dangerous feature. It fails to confront the deep incentive conflicts that tempted Federal Home Loan Bank officials, with the explicit and implicit encouragement of Congress, to lower effective capital requirements in often tricky ways during the late 1970's and early 1980's. Insolvency resolution would continue to focus on the accounting value of enterprise-contributed capital rather than on its market value, and would continue not to impose a formal obligation on the FDIC to intervene strongly and predictably into the affairs of capital-deficient firms before exhaustion of the market value of its capital becomes a serious threat.

When the budget deficit is broadly conceived, most of the changes in the unfunded value of deposit-insurance guarantees that we are worrying about today occurred years ago. Policies of covering up and not explicitly financing FSLIC's implicit losses represent an unhealthy type of "gambling" by politicians and regulators that is encouraged by a crucial defect in the budget discipline under which the Federal Government operates. This crucial defect consists of focusing budget disciplinary entirely on explicit or front-door Government receipts and expenditures, while ignoring the impact of parallel implicit or back-door receipts and expenditures that are inherent in changes in the value of Federal commitments and guarantees.

The main point of my testimony is to ask Congress to recognize officially that economists' traditional distinction between explicit and implicit outlays and receipts implies a parallel distinction between the explicit and implicit Federal deficit. The Government's total deficit has for years been much larger than its reported value. This total deficit includes net returns on the Government's capital

stock and changes in the market value of its explicit and implicit debt.

Losses imbedded in deposit insurance and other guarantee programs deserve to be treated as implicit expenditures precisely because political incentives force Congress and the President to back-stop implicitly all Federal operations.

This is why increased financial weakness of insured deposit institutions may be said to increase the true value of the Federal deficit. Politicians' obsessive concern for minimizing the apparent or explicit value of the deficit has repeatedly persuaded them to delay needed action because these needed actions would have enlarged the Treasury's explicit commitment to the FDIC and FSLIC. This happened most recently in 1987 in the Competitive Equality Banking Act. Ironically, this unwillingness to formalize what is in the last analysis an unavoidable Treasury commitment has been penny-wise and pound-foolish. It has increased interim customer pressure on the thrift industry and the aggregate value of FDIC and FSLIC guarantees. FDIC and FSLIC personnel have been made to work unnecessarily close to the edge of an accounting and bureaucratic disaster that could unravel public confidence in the deposit-insurance system.

Thank you.

[The statement of Mr. Kane follows:]

Prepared Statement
Committee on Ways and Means
U.S. House of Representatives
February 22, 1989

BUDGET IMPLICATIONS OF THE FSLIC MESS

Edward J. Kane*

In public policy, as in medicine and automobile repair, diagnosis precedes prescription. Only by understanding what went wrong with anything can policymakers reasonably hope to put matters right again. With FSLIC, the question is not only how large the bill has become, but how and when it came to be so large. It is not enough for Congress to set up a sensible financing plan for paying off FSLIC's accumulated bill. It must also build a system of controls on future backdoor spending by the deposit-insurance bureaucracy strong enough to make reasonably sure that taxpayers will not be asked to confront such a bill again.

The Need to Demand an Itemized Bill for FSLIC's Debt

FSLIC's unpaid bill is simply the capitalized value of the flow of projected net costs that supporting its guarantees and diverse obligations imposes on federal insurance funds and on the federal taxpayer. To understand this bill and to pay it efficiently, Congress must ask the FSLIC's new FDIC-FSLIC management team to prepare an itemized invoice that breaks down these costs institution by institution. The capitalized value of net FDIC-FSLIC costs represents the taxpayers' equity stake in each FSLIC thrift. The collection of these stakes deserves to be micro-managed as if it were a portfolio of financial claims that are convertible into common stock. Decisions about which firms should be closed or restructured and in what order must be designed to bring the growth of these unwanted equity stakes under control and to see that they are reprivatized without waste or corruption.

The messiest part of the S&L insurance mess is that federal-government capital has in a largely hidden way all but displaced private capital in hundreds of deeply troubled FSLIC thrifts. The regulators whose actions supplied this government capital did not routinely negotiate a properly balanced and explicit claim to these troubled firms' upside potential for future profits.

It is instructive to think of firms whose private capital has been exhausted as institutional "zombies." A zombie thrift is a firm that because of its decapitalization can be regarded as living a malefic and unnatural life-in-death existence. Its debt trades not on the earning power of its assets but on the comfort given by FSLIC guarantees. A zombie's undead existence is socially evil because its operations unfairly squeeze the profit margins of its healthy competitors and raise the deposit-insurance premiums these competitors must anticipate paying in future years. In this way, zombies extinguish private capital in other financial firms, thereby helping to create more zombies.

Putting Accountability into the Bush Initiative

The Bush Initiative of Feb. 6, 1989 focuses on paying the largest part of FSLIC's unpaid bill, by taking over the worst several hundred of thenation's roughly 750 zombies. But the plan is silent on several deeper issues (Shadow Financial Regulatory Committee, Statement No. 39). The most important of these issues is the need to establish accountability for the insolvency-resolution process. Objective procedures need to be developed and promulgated to establish: how firms are to be targeted for takeover, liquidation, or merger; how such actions are to be ordered in time; and how to be sure that healthy deposit institutions and other taxpayers get full value for the funds they supply.

Accountability exists when decisionmakers are made fully answerable for their decisions. In deposit insurance, this means imposing an itemized and timely informational framework within which officials must report, explain, and justify their decisions to act or not act on individual cases.

*Reese Professor of Banking and Monetary Economics, Ohio State University; Visiting Professor, Center for Financial System Research, College of Business, Arizona State University; and Member of the Shadow Financial Regulatory Committee. This testimony draws on Kane (1989).

Establishing accountability is important because insurers' and Congress' lack of accountability for decisions made in the past to reduce effective capital requirements for FSLIC thrifts and to forbear from taking over individual zombie thrifts when they became decapitalized is the crucial defect in public policy that allowed the FSLIC bill to become so large (Kane, 1989).

To underscore FSLIC's past lack of accountability, Table 1 shows how lamely FSLIC was allowed to report its reserve position during the years 1982-1987. It was not required to reserve explicitly for its loss exposure in troubled client firms, either individually (as recommended here) or even in the aggregate. In principle, FSLIC's loss exposure in an individual firm is a decreasing function of the market value of the firm's enterprise-contributed net worth and of the safety of the firm's portfolio and business operations. By classifying clients according to a well-conceived index of their net-worth positions, FSLIC officials could easily have tracked their developing risk exposure in troubled firms. Table 1 calculates timely projections of FSLIC's exposure in firms that generally accepted accounting principles (GAAP) showed to have already exhausted their enterprise-contributed net worth. (Because GAAP estimates of net worth tend to lag behind movements in market values, to account for other zombies, an even more conservative procedure would be to expand the asset base in GAAP-insolvent thrifts by a factor of one-third.) Had Congress imposed this kind of accountability as part of the Garn-St Germain Act in 1982, it and FSLIC officials would have been forced to confront FSLIC's deteriorating situation in 1983 and to see it to be a consequence of the capital-forbearance policies being adopted at this time.

Congress must not mistake this analysis for hindsight. In 1983 I was writing and testifying before Congress about the ongoing deterioration of FSLIC's finances and the unpleasant long-run consequences that were bound to follow from covering up its imbedded losses. The following particularly pithy statement is excerpted from a September 30, 1983 reply to a request for my opinion from Secretary of the Treasury Donald Regan:

"I believe that the system of federal deposit insurance adopted during the 1930s has become as dangerous and as unreliable as an old and undermaintained automobile. While it is okay for flat country, the deposit-insurance automobile cannot be driven endlessly up and down steep interest-rate mountains without breaking down. There is good reason to doubt that the old car still has another interest-rate mountain left in it.

"The avoidance of widespread deposit-institution failures and bureaucratic attempts to paper over the current costs of resolving the *de jure* and *de facto* failures that did occur have fostered the illusion that federal deposit insurance is a miraculously low-cost device for ensuring a stable system of financial intermediation. However, as in a famous series of television commercials made to promote Fram oil filters, agency cost accounting makes an implicit tradeoff between paying for routine maintenance now and paying for heavy repairs later. The true costs imposed by the system are much greater than the accounting record reveals. The more experience deposit institutions have had with the system, the more leverage and interest-rate risk they have wanted to load into the deposit-insurance jalopy. This makes for good downhill riding, but makes the brakes bear a harder load on curves and overloads the motor on grades.

"The point that must be grasped is that, however well the deposit-insurance system may have run in the past, it is moving toward a bureaucratic breakdown. It's not a case of 'If it ain't broke, don't fix it.' Unless market discipline is reimposed on deposit-institution risk-taking, the deposit-insurance bureaucracy is going to seize up at a most inopportune time.

"The realignment of regulatory clienteles envisaged by the Bush Commission responds reasonably well to the political pressure put on Congress and the President by differential regulation and by competition among regulators. But it needs to recognize that the proposed realignment of regulatory clienteles will make it harder than ever for the deposit-insurance agencies to defend their (and the taxpayer's) economic interests against political forces that support subsidies for particular classes of deposit-institution risk-taking.

"Over the last decade, a policy of routinely bailing out all but each agency's most devastated clients has induced a massive and ongoing substitution of equity in the form of deposit-insurance guarantees for private equity in deposit institutions. Through these guarantees, the federal government has become the leading supplier of equity funds to deposit institutions. Without anyone's intending it, the nation is treading a back-door path to the *de facto* nationalization of the deposit-institution industry. This unintended nationalization is symbolized by government operation of so-called 'phoenix' combinations of failed but unmarketable

S&Ls. If and when interest rates surge upward again, the phoenix approach to failure resolution is going to seem irresistibly more attractive. Moreover, the difficulty of returning these institutions to the private sector will grow apace. To avert an eventual crisis, the deposit-insurance contract must be repriced and redesigned to restore incentives to invest private capital in deposit institutions."

Neglected Portions of FSLIC's Unpaid Bills

The February 1989 Bush Initiative has three principal elements:

1. A proposed sizing of the cost of resolving insolvencies at FSLIC-insured thrifts;
2. A financial mechanism for funding this cost from increased explicit deposit-insurance premiums for thrifts and banks and from general tax revenues;
3. A bureaucratic restructuring of the responsibility for resolving thrift insolvencies and for operating the controls used to discipline future risk-taking by thrift institutions.

By explicitly funding most of the Treasury's implicit obligation for current zombies, the Bush Initiative greatly improves on inadequate 1987 legislation that falsely purported to "recapitalize" FSLIC. However, in sizing the problem at \$90 billion, the Administration has chosen not to reserve -- as a private guarantor would -- for FSLIC's anticipated loss exposure in hundreds of thrifts whose economic capital is either slightly positive or mildly underwater. In recent months an upward trend in market interest rates has been weakening such firms. Leaving this roughly \$45 billion liability unfunded puts an unreasonably large bet on the efficiency of the plan's bureaucratic transfer of FSLIC's insolvency-resolution and loss-prevention responsibilities to the FDIC. The plan disingenuously presumes that the FDIC can accomplish the amazing task of raising thrift capital to a 6 percent of assets by June 1991 and can rely on tougher cease-and-desist powers and criminal and civil penalties to restrain future abuse of deposit-insurance guarantees.

The plan's absolute faith in the FDIC to carry this burden is its most dangerous feature. It fails to confront the deep incentive conflicts that led FSLIC (with the encouragement of Congress) to lower effective capital requirements in often-tricky ways during the late-1970s and early 1980s. Insolvency resolution would continue: (1) to focus on the accounting value of enterprise-contributed capital rather than on its market value, and (2) to impose no formal obligation on the FDIC to intervene strongly and predictably into the affairs of capital-deficient firms before a market-value insolvency becomes a serious threat. On the insolvency-resolution side, we have already noted that the plan fails to establish an accountability mechanism to complement the authority the plan transfers to the FDIC. In the absence of an adequate accountability mechanism, prospects for arbitrariness, waste, and corruption are terrifying.

Handing the ball to the FDIC in this way maximizes politicians' ability both to continue to pressure regulators to help troubled firms in their constituencies and to be prepared to blame FDIC officials later for the long-run consequences of this behavior. Before too long, politicians may be scapegoating the FDIC as energetically as they are scapegoating FSLIC today for regulatory "blunders" whose roots lie in Congressionally imposed restraints on what an insurer can do.

The Initiative's economic weaknesses are best understood as political stratagems. An undersizing of the problem serves to minimize the impact of insolvency-resolution expenditures on the explicit federal budgets of the next few fiscal years. It also serves to keep the burdens that must be projected for healthy thrifts, commercial banks, and the general taxpayer low enough to make it hard for these parties to become angry enough to scuttle the plan. At the same time, continuing to frame as matters for regulatory discretion the issues of what is capital and when an institution must be recapitalized or closed maintains Congressional opportunities to collect tribute by offering to perform behind-the-scenes "Constituent services" for owners and managers of troubled institutions.

True Versus Cosmetic Problems

In a currently popular song, a singer implores her listeners to "shove me in the shallow waters before I get too deep." Taxpayers' immediate problem is less a matter of paying FSLIC's bills than of getting zombie and potential zombie firms repaired or off the street and doing this at minimum total cost to federal taxpayers.

Tougher insolvency resolution requires that the lender of last resort avoid lending to insolvent institutions and that decision to pull the plug on individual firms be given greater insulation from political pressure. The Bush Initiative recognizes that, to strengthen the FDIC-FSLIC management team politically, it must first be strengthened financially. It must be assigned sufficient resources to support the charge-offs inherent in taking over client institutions before their capital is exhausted. It must also receive enough budgetary freedom to hire the staff it needs to carry out the tasks of enforcing solvency requirements and bridging the operation of decapitalized firms until private acquirers or investors can be found. To make sure that solvency decisions are objective and economically based, authorities and industry leaders must accept a more meaningful concept of legal insolvency. The criterion developed must focus on the market value of each client's enterprise-contributed capital (Shadow Financial Regulatory Committee, Statement No. 38). Insolvency cannot be permitted to turn on an institution's liquidity because liquidity either is conveyed by federal deposit guarantees or, in truly severe cases, becomes a function of discretionary eligibility criteria laid down by the lender of last resort. Nor can the test be permitted to focus on traditional accounting measures of a firm's net worth, because this value too is favorably impacted by federal guarantees and because existing accounting rules leave firms and regulators considerable opportunity to conceal evidence of *de facto* insolvency.

Prior to the announcement of the Bush plan in early February 1989, the political debate over FSLIC focused itself less on how to recapitalize zombie thrifts efficiently than on a series of politically cosmetic, but economically irrelevant points.

The first concerned an alleged need to keep FSLIC's losses from increasing the national debt. Because FSLIC's bill is effectively (i.e., implicitly) already part of the national debt, entering the obligation explicitly on the books of the Treasury would not increase the federal deficit or the national debt as these concepts should properly be construed. All that is at issue is converting into an explicit obligation what is already an implicit (or *de facto*) Treasury obligation and one whose relevance has been confirmed twice by joint Congressional resolutions.

The second cosmetic issue focused on a supposedly heroic fight to keep taxpayers from bearing any of the bailout burden. Pride in having kept "federal money" out of the FSLIC bailout process as long as possible reflects and perpetuates longstanding forms of accounting deception and defective economic analysis. Implicit federal expenditures have been made on behalf of FSLIC for years and in substantial amounts. These expenditures have two main components. The first and largest part consists of annual financing costs implied by the Treasury's conjectural obligation to support FSLIC debt to prevent FSLIC from permanently defaulting on any of its diverse corporate obligations. The second part consists of tax benefits that have for years been accorded routinely to acquirers of failing thrifts. These benefits have two elements: (a) a right to carry forward the acquired thrifts' past losses and to deduct them against the acquirer's other taxable income and (2) full or partial exemption from federal income taxation of FSLIC assistance payments. These tax forgivenesses represent collectible tax revenues that could have been sent to the Treasury and shipped to FSLIC for explicit disbursement. The fact that the Treasury has chosen to hand these funds directly back to the institutions to which FSLIC would have directed its disbursements does not prevent the values that are transferred from being forms of federal tax money.

The third cosmetic question turned on the sacredness of past Congressional pledges to control federal spending. Using concerns about keeping explicit federal outlays low under Gramm-Rudman-Hollings provisions as an excuse for keeping a large number of zombie thrifts in play promotes false economy. It employs the letter of the Gramm-Rudman-Hollings law to violate its very spirit. To be meaningful, budget discipline must apply to implicit and explicit expenditures alike. The longer that authorities permit zombie and near-zombie firms to survive without recapitalization and the larger the number of these firms allowed to stay in operation, the higher the overall bill becomes for cleaning up FSLIC's past mistakes.

The fourth distracting issue concerned the relative importance of George Bush's campaign pledge to impose "no new taxes." This promise threatens to become yet another excuse for deferring an adequate refinancing of FSLIC obligations. Initial skirmishing over the Bush administration's January 1989 proposal to retire FSLIC's shortage over time from the proceeds of a 25 or 30 basis-point charge on customer deposits at banks, S&Ls, and credit unions is not encouraging. The debate focused on the semantic issue of whether the charge should or should not be construed as a "tax." If anything, administration efforts to portray the charge as a long-overdue modernization of "user fees" for federal deposit insurance and to refute opponents' claim that it could reasonably be interpreted as an excise tax

struck a note of intellectual slipperiness that helped to harden opposition to this measure.

The irony of these cosmetic issues is that focusing on them allowed the same failures in government accounting that helped the FSLIC bill to grow so large in the first place to interfere with settling FSLIC accounts in an economically efficient manner. The fundamental issues in paying this bill are only two: (1) how to assure that taxpayers get full value for every dollar they put up and (2) how to distribute the burden of providing these dollars both over time and across the universe of taxpayer types.

Gramm-Rudman-Hollings provisions and the no-tax pledge should not be allowed to become counterproductive constraints on how efficiently these issues are resolved. To distort in this way efforts to clean up the FSLIC mess is to use cosmetics to perpetuate and increase ugliness. Not appropriating or borrowing resources adequate for the job resembles asking emergency-room personnel to use only 40 feet of sutures to close every hundred feet of open wounds brought to them for treatment. It makes more sense to send out for additional surgical thread than to sew up only two inches of every five-inch wound.

Making Congress Accountable for Backdoor Spending

Policies of covering up and not explicitly financing FSLIC's implicit losses represent an unhealthy type of "gambling" by politicians and regulators that is encouraged by a crucial defect in the budget discipline under which the federal government operates. This crucial defect consists of focusing budget discipline entirely on explicit government receipts and expenditures, while ignoring the impact of the parallel implicit receipts and expenditures that are inherent in changes in the value of federal commitments and guarantees.

When the budget deficit is broadly conceived, recent changes in the unfunded value of deposit-insurance guarantees loom large relative to reported budget deficits. Nevertheless, throughout the 1980s political pressure to minimize the reported or explicit federal deficit noticeably constrained FDIC and FSLIC efforts to reduce the value of their own implicit losses.

The main point of my testimony is to ask Congress to recognize officially that economists' traditional distinction between explicit and implicit outlays and receipts implies a parallel distinction between the explicit and implicit federal deficit. The explicit deficit, D_e , is defined as the difference between explicit outlays (government spending, G , and interest on government debt, IB) and explicit receipts (tax receipts net of transfers, T): $D_e = G + IB - T$. This budget concept, which governs the Treasury's need for explicit finance, has until now served as the primary focus for public debate. However, the total deficit includes unconsumed - returns on the government's capital stock and changes in the market value of its explicit and implicit debt. Implicit government debt includes the expected value of unfunded commitments to provide future government assistance of all sorts. Contractually, these commitments constitute the reverse side of citizen "entitlements" to items such as social-security payments and welfare expenditures and of anticipated bailouts for politically strong firms and industries.

My testimony concentrates on only one form of implicit federal debt: the market value of unfunded FSLIC guarantees of liabilities in troubled thrifts. The calculations shown in Table 1 imply that, between yearend 1982 and yearend 1987, the value of these unfunded guarantees increased by many billions of dollars.

Losses imbedded in FSLIC and FDIC operations deserve to be treated as implicit expenditures precisely because political incentives force Congress and the President to backstop implicitly all formal FSLIC and FDIC guarantees. When a thrift institution is allowed to operate as a zombie, depreciation in the value of the assets it holds is largely offset by appreciation in the value of the deposit-insurance guarantees it enjoys. Entries for the value of FDIC and FSLIC guarantees belong on the balance sheets of insured thrift institutions and of the deposit-insurance agencies. Because explicit FSLIC and FDIC resources are only a small fraction of these guarantees, the liability should be passed through onto the Treasury's generalized balance sheet as an implicit decrease in its net worth.

This is why the financial weakness of insured deposit institutions may be said to increase the true value of the federal deficit. Politicians' obsessive concern for minimizing the apparent or explicit value of the deficit has repeatedly persuaded them to delay needed actions because these would have enlarged the Treasury's explicit commitment to the FDIC and FSLIC. Ironically, this unwillingness to formalize what is in the last analysis an unavoidable Treasury commitment has increased interim customer

pressure on the thrift industry and has increased the aggregate value of FDIC and FSLIC guarantees. FDIC and FSLIC personnel have been made to work unnecessarily close to the edge of an accounting and bureaucratic disaster that threatened to unravel public confidence in the deposit-insurance system.

Summary Perspective

In 1988, no candidate for President or for Congress made the need for deposit-insurance reform a major issue in his or her campaign. Nor did the Reagan budget for 1989 embody an adequate program for cleaning up the FSLIC mess. Although George Bush deserves credit for officially resizing the problem, he has not delivered the bad news to taxpayers that the most-promising way to straighten things out is for their elected representatives to tote up the entire bill and to pay or finance this bill promptly. Neither he nor any other politician seems ready to propose the restrictive accounting reforms for tracking the future value of backdoor spending through government guarantees that disgruntled taxpayers would be well-advised to require.

REFERENCES

- Kane, Edward J., 1989. The S&L Insurance Mess: How Did It Happen? Washington: Urban Institute Press (forthcoming).
- Shadow Financial Regulatory Committee, 1988. "Statement on the Need to Estimate the True Economic Condition of the FDIC," Statement No. 36, Chicago (Dec. 5).
- _____, 1989. "An Outline of a Program for Deposit Insurance and Regulatory Reform," State No. 38, Chicago (Feb. 13).
- _____, 1989. "Statement on the Administration's Plan to Resolve the Thrift Crisis," Statement No. 39, Chicago (Feb. 13).

Table 1
Comparison of Official Estimates of FSLIC Reserve Position
with Conservative Estimates of FSLIC's Imbedded Loss
in GAAP-Insolvent Firms, 1982-1987
(in \$ billions)

	Official Estimates of FSLIC's <u>Total Reserves</u>	Total Assets in GAAP- Insolvent <u>Firms</u>	FSLIC-Reported Resolution-Cost <u>Rate</u>	Year-by-Year Projections of FSLIC's Imbedded Loss in GAAP- <u>Insolvent Firms</u>
1982	6.3	67.8	4.55%	3.1
1983	6.4	83.9	5.93%	5.0
1984	5.6	115.5	14.62%	16.9
1985	4.6	138.0	16.04%	22.1
1986	-6.3	137.2	24.61%	33.8
1987	-13.7	200.1	34.74%	69.5

Source: Column one: Federal Home Loan Bank Board, 1987 Annual Report. Columns two and three are drawn from Barth and Bradley (1988). Column four is calculated as the product of columns two and three.

Chairman ROSTENKOWSKI. Thank you.

Your testimony, Mr. Carron, states that a legislative solution for resolving the thrift crisis should seek the least costly methods. Do you believe that an efficient financial solution would include extension of the special tax rules granted to troubled banks and thrift institutions?

Mr. CARRON. I do not have an opinion on that one way or the other. My remarks were directed more toward the use of a new agency to raise funds versus raising those funds directly through the Treasury.

Chairman ROSTENKOWSKI. You do not have any opinion on that?

Mr. CARRON. On the prior subject, no, sir.

Chairman ROSTENKOWSKI. Mr. Kane, you mentioned the lack of accountability of the FSLIC. In your opinion, does this extend to the manner in which tax benefits are evaluated and transferred by the FSLIC?

Mr. KANE. It does. I think Congress needs to specify what interest rate FSLIC should use in making these calculations. I understand that they use the interest rate paid on FICO bonds instead of the Treasury's interest rate. A higher interest rate will, of course, lead to an understatement of lost taxes and the tax benefits. Also, even the rules for calculating the tax benefits should be decided by some outside party rather than by people who have a bureaucratic interest in making their activities seem to be efficient.

Chairman ROSTENKOWSKI. Mr. Pickle?

Mr. PICKLE. There has been considerable talk at one point or another about what to do with savings and loan, thrift institutions. The action within the last 2 or 3 weeks literally has forced FSLIC institutions under the FDIC. The question is: Should we have a separate thrift industry?

Mr. Maisel, you said there is a real value in keeping them separate and apart and continuing. And yet on the other hand you said they should be merged, FSLIC and FDIC. Now, how can they do both? How would you envision that?

Mr. MAISEL. I believe that the funds can be the same. We have had savings banks in the FDIC almost from the start. The mutual savings banks have always been insured by the FDIC, and yet they have remained a very major part of the thrift industry. So I do not believe having a single fund will affect the question of whether we have a separate thrift industry.

Mr. PICKLE. Well, then, you would not be for FSLIC becoming a separate agency?

Mr. MAISEL. No. As I say, I would think we would put them—

Mr. PICKLE. You would put them under FDIC but limit them to thrift matters.

Mr. MAISEL. That is correct, by their charter, by their regulations, and by tax savings.

Mr. PICKLE. All right. Now, years ago, when we deregulated the banks and the S&L's at the same time, we really allowed the S&L's to participate in almost any activity. They are the same as a commercial bank, very little difference.

Mr. MAISEL. Right.

Mr. PICKLE. They may emphasize differences in some aspects, but, still, they are basically a bank. Now, if we continue them as a thrift institution, would we then "regulate" them again?

Mr. MAISEL. I think it was a mistake to deregulate them. One of the questions that has been raised is to why this cost us \$100 billion, and my answer is that deregulation was a major error. They were allowed to go into all sorts of new things that they were unprepared for. There was insufficient supervision as to what they were doing.

I have examined several of the failed institutions, and in almost every case, the losses came from deregulation. They went into areas in which they had no management skills in. They went into all sorts of deals that they could not have done previously. I think when the picture comes out, you will find that very little of that \$100 billion came from home loans; that the vast majority of it came from allowing S&L's to go out of the home loan industry into other types of loans.

Mr. PICKLE. We do not know which direction, of course, we will go, but the biggest problem, we have to admit, is the continuation of our present control.

Do we create another off budget, quasi-governmental agency to provide the \$50 billion? We might get our money back if interest eventually can equate to the maturity of the bonds. But we also could lose a lot of money in the process. And I think the biggest criticism we all must accept is that there has been no real audit, no real warning, no control over any of these off budget items. That is true whether it is Fannie Mae, Ginnie Mae or Sallie Mae. We really have all just kind of taken these audits in a cursory manner, and we looked the other way.

It is not just the fraudulent deals that have caused S&L problems. I am afraid this is just the expanded economy and the risk and the lack of accountability, and we all share in that.

Now, if we create another agency, we are going to just continue the same thing, and yet we cannot do as Mr. Carron said. I do not think we could take it out of general revenue. You think a general revenue bill of \$50 billion to help the S&L's would pass this Congress? Not likely. We do not know where we will get the money. But I do think, as we go forward, that one of the biggest problems of all is we do not have any control at all of these off budget, quasi-governmental agencies, whether it is explicit or implicit, Professor Kane, as you say.

That is the big problem we have got to face. How do we stop this, and how can we control it? I think it is going to be a lot of bloodletting before it is finally done. But your testimony has been helpful, and I thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Vander Jagt?

Mr. VANDER JAGT. I would just like to thank the members of the panel for sharing your expertise and knowledge with us, and for your patience and endurance in making your knowledge available to us. Thank you very much.

Mr. PICKLE [presiding]. Mr. Andrews?

Mr. ANDREWS. Mr. Carron, in your testimony, you suggested that we do a couple of things with thrifts. One, you suggested we

remove the requirement that thrifts hold 60 percent of their total assets in housing-related instruments. I tend to agree with that. You also suggested, I think, basically that thrifts need more flexibility in trying to deal with changing market conditions, that maybe that has not happened in the past, and I agree with that.

Finally, you suggest at the end of your testimony that we ought to consolidate some of the regulations, regulatory oversight, and I think that certainly appears, from what has happened in the last 6 months, to make good sense.

Are we getting to the position in a marketplace where there really is going to be a financial institution that is really not an S&L and not a bank? Is it really important, as you suggest, that we have an S&L industry, as we have known an S&L industry in the past?

Mr. CARRON. I think that we will continue to have institutions which will look very much like today's S&L's. They will concentrate on collecting deposits from small savers, home mortgage lending, and, to a lesser extent, consumer lending. All I am suggesting is that they should not be required by regulation to do so; that we should permit them the flexibility, should they desire, to change their deposit and liability mix over time as market conditions may require them to do.

Mr. ANDREWS. Mr. Maisel, you are smiling. Do you have a comment?

Mr. MAISEL. Yes. I disagree. I think, as I say, it was a mistake allowing the S&L's to spread out as they did, that this is what has caused most of the large losses. I think we can have—and there are advantages of having—institutions which are restricted to fairly risk-free loans.

Mr. ANDREWS. What are they? What are the advantages? What is the advantage? What difference does it make? If we have appropriate regulation, if there really is a financial center that is secured, that is insured, that is properly regulated, what advantages are there?

Mr. MAISEL. I think the answer is that we cannot have proper regulation. In other words, when you make that statement that we have proper regulation, you are just putting too much belief in what the regulator can do. I have looked at this from both sides, and I think there is simply an overestimate of what the regulator knows. You will find that in most of these institutions the management did not know what risks they were taking and their losses. Clearly, the auditors did not know. The regulators who were coming in at a third level have even less chance of knowing what is going on.

I think the critical thing, and as I say, this is what we looked at for the National Science Foundation about 12 years ago, and the main point we made was that you had to have adequate capital. If you have adequate capital, then regulation really does not matter much. But you want to relate the capital to the risk. If you have institutions which only do home lending, the amount of capital they need is far less. In fact, under the proposed regulations for capital adequacy, home mortgages have half the requirements, half the capital requirements of other types of mortgages.

I think this is a proper way to move.

Mr. ANDREWS. Well, I guess a query is: Isn't one part of this debate the fact that the market forces here, good or bad, are also driving the demands on these institutions? And I think what Mr. Carron is suggesting in his testimony is that just in trying to respond to market forces that we cannot regulate—we cannot suggest what they are going to be 5 years from now, but possibly—where we are headed is much less of a need of an S&L institution as we have known it in the past. You would agree with that?

Mr. MAISEL. I agree that it is a possibility. As I say, I think, though, that over the last 40 or 50 years, having thrift institutions, savings banks and savings and loans, has turned out to be worthwhile for the country. I think we have more homes than we would otherwise have. I think we have had more of our savings go into the home industry than it would have if we had not had these institutions.

Mr. ANDREWS. Mr. Kane?

Mr. KANE. I would like to disagree with my colleague, Sherman Maisel, in a number of ways, but to point out one way in which all three of us agree. We all agree that capital adequacy is the key to protecting deposit insurance. This means a reasonable closure rule. But I have done some studies on the differential behavior of firms that are respectively solvent and insolvent on the basis of GAAP or generally accepted accounting principles. The issue is how either having negative capital or positive capital affected how S&L's went into the new opportunities that were available to them under the 1980 and 1982 deregulation acts.

If we look at 1988 in the second quarter, we will find that the actual difference in GAAP net worth in these two types of firms as a percent of total assets was 19.1 percent. But the differences in the use made of new powers is much smaller. Even if we assumed every differentially invested dollar was lost—was thrown away—when a GAAP-insolvent firm put it into one of these new enterprises, it only accounts for a difference of 8.4 percent in the ratios. So about a third of the differential losses could have been in new opportunities. The key to the rest is that if you do not have any of your own capital up front when you are investing, then you are attracted to actuarially bad deals. This is true whether we look at new opportunities that you have not had available to you before or whether they are old opportunities.

I agree with you that the market forces were driving firms out of traditional businesses. And, in fact, there are a number of subsidies in the markets for mortgage-backed securities that are hurting thrifts, through Fannie Mae and Ginnie Mae and so on. Low margins in these traditional businesses led them to push for other opportunities.

The final point I would make is that home mortgages are not riskless assets. The beginning of this FSLIC problem is the interest rate increase that wiped out the capital of the industry and much of the industry during the 1970's and left many of these firms going into the 1980's severely decapitalized and thereby attracted to go-for-broke opportunities. So while I acknowledge that the risk-based capital scheme treats mortgages favorably, it does not do so for economic reasons. It does so for political reasons. A lot of political pressure was generated to go easy on mortgages. But mortgage

lending created the roots of the problem we have today. A lot of other things nurtured and worsened the situation subsequently.

Mr. ANDREWS. Thank you.

Mr. PICKLE. Are there any other members who wish to be recognized at this time? Mr. Moody?

Mr. MOODY. Yes.

Mr. PICKLE. The Chair recognizes Mr. Moody.

Mr. MOODY. Mr. Maisel, you obviously do not agree with that last statement.

Mr. MAISEL. I think the point is that there are two risks in a mortgage. One is the interest rate risk and one is the credit risk.

Mr. MOODY. You are talking about the disintermediation problem, right?

Mr. MAISEL. It was the interest rate risk that caused the problem. In the capital structure requirements, there is a different requirement for the interest rate risk. This, therefore, is the difference. If you think of the two separately, the home mortgage without the interest rate risk is far less risky.

Mr. MOODY. Right. All of it could be regional. The usual statistical spread might be skewed by the fact that they are concentrated in a region such as the oil patch where all the homes suddenly become less valuable because people are losing their jobs.

Mr. MAISEL. Right.

Mr. MOODY. I will not take a lot of time, but I want to ask if any of the three of you wish to comment on the GAO report this morning. I assume you heard or remember most of their main points. It was a pretty critical review of the President's proposal and of the "December deals." Those are obviously separable issues.

Do any of you want to comment on the GAO testimony? Do you agree or disagree with it?

Mr. CARRON. I think I agree with Mr. Bowsher on the President's proposal that it basically goes in the right direction, but I share with him his concern that the cost estimates may not be large enough.

Mr. MOODY. Do you agree that it would be better to handle this thing up front rather than through the back door, so to speak?

Mr. CARRON. Absolutely.

Mr. MOODY. Yes, I gather that from your testimony. Do you think there would be a substantial spread in the eventual cost by doing it one way versus another?

Mr. CARRON. We have estimated that the REFCO bonds would probably require an interest rate somewhere in the range of 25 to 40 basis points more than a comparable Treasury, which in round numbers would add somewhere around \$2 billion to the total cost of the plan.

Mr. MOODY. In present value terms?

Mr. CARRON. In present value terms.

Mr. MOODY. So we are talking real money, although it is not overwhelming relative to the size of the problem.

Professor Maisel, do you agree?

Mr. MAISEL. Well, I think there were two points that I thought were the main one. That is, that the tax expenditures are more expensive. These were given to firms in all sorts of different tax status, so that clearly they had to be different. Secondly, the firms

had a much better idea of what they were going to gain from them than the Government did.

Mr. MOODY. Because the firms knew more about their internal P&L and bookkeeping and so forth.

Mr. MAISEL. Right.

Mr. MOODY. And so they were not exactly bargained on an equal base of information.

Mr. MAISEL. Right. Thirdly, I think you have been left with weak, undercapitalized firms. In other words, if you look at it, Chairman Wall made the point that the capital was behind half the assets, and the Government was behind the other half. But this puts all the firm to give them great benefits to see that all the costs go on the Government half and minimal costs go on their own half. So I think the Comptroller General's point was you have left a very, very difficult regulatory problem with the institutions.

Mr. MOODY. A huge burden.

Mr. MAISEL. Right.

Mr. MOODY. Mr. Kane, do you have a comment on that?

Mr. KANE. Well, I am of two minds about the December deals. That is, if you look at them just in themselves, they did have excess costs to the Government, but they helped to move us toward where we are finally doing something about FSLIC, finally sewing up some of its wounds. I feel if I were in the same position that the members of the Board were—

Mr. MOODY. And if you did not have the cash to do it.

Mr. KANE. Yes. They used the weapons that had been given to them to fire. They fired them as best they could with what training they had. Obviously, they faced very sophisticated problems that the other side would tend to outweigh them on, but Congress gave them those tools.

Mr. MOODY. The question is: Should we continue the heavy use of tax benefits from here forward?

Mr. KANE. I think that you should not. I think that just as Professor Maisel said, it is likely that these tax benefits will be picked apart. The process resembles adverse selection in insurance. People will take tax benefits if that is better for them than cash, but that means that the Government will be giving them an option that says, "Do you want to receive cash or do you want something that is even more valuable."

Mr. MOODY. Right. Mr. Carron, do you agree with that last comment?

Mr. CARRON. I would agree as a general proposition, but there may be some particular cases I am not aware of that would—

Mr. MOODY. Sure. It is sort of a heads I win, tails you lose proposal.

Mr. CARRON. Right.

Mr. MOODY. Thank you, gentlemen.

Mr. KANE. You asked also about the cost estimates the other witnesses presented. I think the cost estimates are very narrowly focused, as I said, on institutions that are severely insolvent. They put aside the problem of keeping thrifts that are marginally insolvent or nearly insolvent—that are stressed and distressed at from becoming future zombies. And so unless that is recognized to be part of the problem, unless that is solved, then we are just paying

part of a bill that is still going to grow. We will get some relief for a little while, but the pressure will be back with us before too long.

Mr. MOODY. Thank you very much.

Mr. PICKLE. Thank you, Mr. Moody.

I want to thank the panel. You have come to us with some good testimony. I know it will be helpful, as has been the rest of the testimony of the agencies we have had today. It has been a good hearing today.

Now, we are going to be adjourned now, but we will meet again on the morning of March 9 at 10 o'clock in this room. The committee stands adjourned.

[Whereupon, at 3:14 p.m., the committee adjourned, to reconvene at 10 a.m., Thursday, March 9, 1989.]



BUDGET IMPLICATIONS AND CURRENT TAX RULES RELATING TO TROUBLED SAVINGS AND LOAN INSTITUTIONS

THURSDAY, MARCH 9, 1989

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. Good morning.

Today we continue hearings reviewing the budget implications and current tax rules relating to troubled savings and loan institutions.

Today the committee will continue its consideration of these issues: First, what were the costs associated with the Federal Home Loan Bank Board's actions in transferring 75 troubled thrift institutions in December of 1988.

During our first day of hearings we heard that the costs of these December deals could be substantially higher than estimated by the bank board, and that the tax benefits transferred in December could be over \$7 billion.

This committee must determine whether the Federal Government received full value for these tax benefits, and we must review the soundness of the special tax provisions which provided these benefits.

Second, the committee will continue its review of the three special tax benefit provisions assisting troubled savings and loan institutions and banks. The first day of hearings provided disturbing information regarding the manner in which these tax benefits have been valued and transferred.

These special tax benefits will expire at the end of this year. Obviously, the extension of these provisions would result in a revenue loss.

As I have stated beforehand, if the administration believes that these special tax benefits are useful, then a potential extension and its cost should be considered as part of the administration's comprehensive assistance package and not as separate legislation later in the year.

Only in this way can the Congress be assured that the American taxpayer will have a full understanding of the total costs of the savings and loan assistance program.

The third major area for the inquiry for the committee is the administration's assistance proposal. This proposal has been recently introduced in the House as H.R. 1278. This committee has concerns regarding revenue and debt management issues in the legislation. Accordingly, if the House Banking Committee passes the legislation without substantive changes in the areas of this committee's jurisdiction, then I anticipate that this committee would receive sequential referral and consider the bill.

But as I have previously stated, I do not intend to delay or otherwise hamper the passage of this important piece of legislation, nor do I anticipate reviewing those aspects of the proposal which are properly within the responsibility of other committees. Our job in this committee is to judge whether the revenue and Federal debt aspects of the administration proposal provide the most efficient means to solve the thrift crisis.

Today we will be hearing from Mr. Roger Jepsen, Chairman of the National Credit Union Administration. We will also receive testimony from members of industry groups, other industry experts, and members of the public.

Next Wednesday, March 15, the committee anticipates receiving testimony from Nicholas Brady, Secretary of the Treasury on these issues and the President's fiscal year 1990 budget.

Mr. Jepsen, you may proceed.

STATEMENT OF HON. ROGER W. JEPSEN, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION BOARD, ACCOMPANIED BY ROBERT FENNER, GENERAL COUNSEL, AND D. MICHAEL RILEY, DIRECTOR, OFFICE OF EXAMINATIONS AND INSURANCE

Mr. JEPSEN. Thank you, Mr. Chairman, and members of the committee. I appreciate the invitation to appear before you today to discuss the National Credit Union Share Insurance Fund. My testimony will deal with the facts. It will be somewhat unique. I know you have not heard many insurance funds success stories lately, and as chairman of the NCUA I thank you for the opportunity to provide the facts of the success of the National Credit Union Share Insurance Fund.

Mr. Chairman, in your district in Chicago there are credit unions ranging in size from 180 members at the St. Martin De Porres Parish to over 11,000 at Zenith Federal Credit Union. The assets range from \$94,000 to \$22 million.

Large or small, each credit union provides its members with personal service and access to credit that may be otherwise unavailable.

The credit union option for financial service has been in existence for over 50 years, and I can say without a doubt or any reservation whatsoever that the administration's plan, which calls for changing of the structure of this fund endangers the entire credit union movement.

The fund is healthy, it works, and in fact it is fail-safe. Rather than changing it, Congress should consider using it as a model for the other financial insurance funds.

In my testimony today, Mr. Chairman, I will present the history of the Fund, describe its structure, expand on its unique adminis-

tration, report on its operation and give the facts and rationale that conclusively show why the most successful National Credit Union Share Insurance Fund should not be changed.

First, some brief background on the NCUA and the National Credit Union Share Insurance Fund. NCUA is the Federal agency that charters, insures, and supervises Federal credit unions. The agency operates without Federal tax dollars; we are funded solely by credit union fees and assessments.

Within NCUA is the National Credit Union Share Insurance Fund, which also operates without tax dollars, and has a current equity ratio of 1.26 percent. This means that we have \$1.26 on hand for every \$100 of insured shares.

This equity ratio is the strongest in the business and exceeds the ratio recommended for banks and S&L's in the administration's bailout plan, and I might add that is has done so every year since it was restructured and modernized in 1984.

The National Credit Union Share Insurance Fund was established in 1970, and unlike the FDIC and the FSLIC, the National Credit Union Share Insurance Fund was launched with no startup capital from the U.S. Treasury. Insurance premiums from insured credit unions were its primary source of income for the first 14 years.

However, during the early 1980's, insurance losses skyrocketed and over 1,200 credit unions were merged or liquidated. Fund equity of less than \$200 million was exceeded by contingent liabilities and asset guarantees. At the same time credit unions were growing at record rates, outpacing the ability of insurance premiums to keep the fund at an adequate level.

In 1982 the Fund began assessing extra premiums, and by 1983 was charging every insured credit union double premiums or one-sixth of 1 percent. By 1984 the equity-to-insured-shares ratio stood at a dismal .25 percent.

I said this testimony would be unique and this is beginning to sound very familiar.

A key element in the Share Insurance Fund's uniqueness took shape in 1983. The credit union community—in their usual do-it-yourself spirit—started to discuss the best way to restructure and modernize their deposit insurance and fund. Letters were written, issues were debated, speeches were made, and public forums were held all to develop the best plan.

Credit unions, trade associations, NCUA and Congress worked together to develop legislation that would create a deposit insurance fund that would be financially safe and sound under any and all circumstances.

A capitalization plan was presented to Congress and was unanimously approved as part of the Deficit Reduction Act of 1984. Public Law 98-369 was signed by President Reagan on July 18, 1984.

Now the key points of the capitalization legislation are as follows.

First, the capitalization plan, as approved by Congress, provides that 1 percent of insured shares be deposited into the Fund by credit unions.

Two, it provides an annual growth adjustment to ensure that 1 percent of credit union shares remains current.

Three, it provides NCUA with the authority to assess annual premiums of one-twelfth of 1 percent.

Four, it provides that if the total assets of the Fund were to ever reach a point that it was less than 1 percent of the total insured shares all insured credit unions would be assessed the necessary amount of money to immediately return the Fund to the 1 percent level.

I suggest, Mr. Chairman, that the above four provisions of this formula make the Fund virtually fail-safe, and it has a track record to prove that.

Another point in the formula provides, as the administration's recommendation does for the FSLIC and the FDIC for a rebate or dividend if the Fund equity exceeds the normal operating level of the Fund. Our normal operating level is set by statute at 1.3 percent. We have an operating range of 1.25 to 1.3 percent. We are currently at 1.26 percent.

After this legislation was approved in the self-help tradition of the credit union movement, checks from 15,000 insured credit unions totaling \$800 million began pouring into the Fund in January of 1985. These checks ranged from almost \$20 million to less than \$200 as each credit union, depending on its size, contributed its 1 percent.

Because of the unique way the Government accounts for its funds, the capitalization plan reduced the national deficit by nearly \$1 billion in 1985, and because of the way that it worked, and because the 1 percent deposit is adjusted annually and the Share Insurance Fund has been profitable each year, the offsetting effect on the national deficit today has increased until it is now almost \$2 billion.

Today, the Fund is, by all measures, the safest and soundest of financial institution's insurance funds. Its equity ratio of 1.26 percent compares to the current FDIC ratio of .83 percent, or 83 cents per \$100, and of course the FSLIC ratio is negative.

Because the Share Insurance Fund has performed so well over the past 4 years, credit unions have had their annual insurance premium waved. To say that credit unions do not pay a premium, as a lobbyist for the Independent Banker's Association likes to say is misleading and it is inaccurate.

Since it was capitalized 4 years ago, the Share Insurance Fund's financial performance has been so strong that a premium assessment has not been required.

However, if the Shared Insurance Fund's operating ratio should fall below the normal operation range of 1.25 to 1.3 percent, a premium would be assessed. Further more, the requirement that annual growth adjustments be made to keep the fund at the 1 percent level has resulted in credit unions depositing \$689 million in to the Fund since 1985, which I would hasten to point out is more than if they had charged a one-twelfth of 1 percent annual premium.

In fact, Mr. Chairman, the total net effect over the last 4 years of the credit unions stepping up to the cash window to provide for

safety and soundness of their insurance fund is equivalent to 17 years of premiums.

Mr. Chairman, the credit union insurance system has two distinct advantages over the "premium based" funds of the banks and the S&L's.

First of all, credit union insurance losses are paid and fund equity is maintained on an accurate and on a current basis. To ensure the integrity of this process, the Fund's books and records are maintained in accordance with generally accepted accounting principles. All actual insurance losses and a percentage of problem code credit unions, based on recent loss experience are provided for as a current expense.

Two annual outside audits, one by the U.S. General Accounting Office and one by a "big Eight" accounting firm verify the numbers. The three-tiered system for assessing credit unions—namely, that of foregoing the interest on their 1 percent deposit, insurance premiums if needed, and the replenishment of the 1 percent deposit annually—insures that fund equity is maintained, whatever the loss.

Thus credit unions operate a "pay as you go" insurance system. There is virtually no way that losses can build up over time to the point where a U.S. Treasury/taxpayer bailout would be necessary. There can be no FSLIC crisis in the credit union movement.

The Share Insurance Fund currently has established specific loss reserves of about \$30 million and has additional reserves of nearly \$400 million. Conservatively speaking, it would take losses of more than ten times the 5-year average for the Share Insurance Fund to deplete these reserves. To deplete the whole \$2 billion fund losses would have to be more than 50 times the past 5-year average.

The second advantage, Mr. Chairman, of the credit union insurance system lies in the deposit-based method of capitalization. Insured credit unions carry this 1 percent deposit as an asset. They have an investment, an ownership interest in the fund. They simply do not pay a premium, expense it, and forget about it. They have a clear and immediate stake in the soundness of their fellow credit unions, and I think that is healthy for the credit union system, and I think that is healthy for any regulator, regulated organizational setup.

The NCUA board recognized in the early 1980's that deregulation of insured credit unions could be successful only if accompanied by close supervision. In 1982, when the NCUA board deregulated Federal credit unions share account rates, it established a commitment to annual examinations of all Federal credit unions, and that, Mr. Chairman, has been done.

The commitment continues today.

In addition, over the last 4 years we have added more than 200 new positions to our examiner work force. We have committed over \$9 million to an intensive and comprehensive examiner training program.

Working with the State credit union regulators, we have developed uniform procedures in key areas such as computerized core examinations, and collection and analysis of call report data. We provide basic training for most of the new State examiners and

provide special training for both examiners and credit union managers where special problems exist.

An example of this are the special agriculture lending seminars we conducted in States experiencing a depressed agriculture economy. The depressed economy of the energy States were also provided special training.

We have reached agreements with the State regulators that ensure NCUA's role in the supervision of all federally insured State chartered credit unions that present significant risks to the National Credit Union Share Insurance Fund.

As a condition of insurance we require that State credit unions meet Federal standards in key areas such as capital accumulation, accounting procedures, "insider" lending, and fidelity coverage.

Very importantly the results of these efforts are self-evident. We have reduced insurance losses from \$1.28 for every \$1,000 of insured shares in 1982 to \$0.38 per thousand in 1988.

Independent action and aggressive risk-based supervision are basic to the history and the operation of the National Credit Union Share Insurance Fund and should be for all financial institution insurance funds.

The banks, savings and loans, and credit unions have different statutory powers and offer different services. Likewise, the degree of risk in each financial industry is different.

Credit unions offer primarily small consumer loans, while banks make larger commercial and real estate loans, and in addition are involved in LBO's, foreign deposits, and international lending.

Also, the investment authority of banks is much broader than that of credit unions, which invests only in Government securities or Government-backed investments.

In short, Mr. Chairman, the risk inherent in credit unions are of far lesser nature than those in banks and savings and loans.

Even with less asset risk, credit unions have the highest reserved assets ratio among financial institutions currently at 6.9 percent.

Mr. Chairman, any financial industry insurance fund that expects to weather trouble must be thoroughly grounded in risk prevention. The National Credit Union Share Insurance Fund is set up with just that objective, and all of our policies at NCUA are also based on that tenet.

The National Credit Union Share Insurance Fund is working very well. It is virtually fail-safe because of its unique structure. To change something that is working this well does not make sense.

The administration proposal calls for writing down the credit union 1 percent deposit over 8 years, and then returning credit unions to a premium-based payment system. This change would cause our equity ratio to decline from its current 1.26 percent to 0.57 percent, thus endangering the safety and soundness of the Fund. It wouldn't take long for another FSLIC-type crisis to arise if the Share Insurance Fund declined to such a level.

In conclusion, Mr. Chairman, the credit unions of this country have an insurance fund that is rock-solid; it is time-tested, and worth emulating by others in the financial services industry.

The credit union movement is generally overlooked as a source of innovative thinking, mostly because of its size. One bank, Citi-Corp, has \$40 billion more assets than all the 15,000 credit union

assets combined. But, as we know from David and Goliath, the size of the player is merely a distraction.

I urge the Congress to consider restructuring the other financial insurance funds to help insure that the FSLIC crisis never repeats itself. The National Credit Union Share Insurance Fund was restructured and modernized in 1984. It has a tested and proven track record, and it is working very well, and should not be changed.

Mr. Chairman, I thank you for the opportunity to tell our credit union story. I have served in the halls of this Congress for a few years, as well as in the State legislative bodies, as well as having a business in the private sector. Whereas, the assurance that we were not to be included in the FSLIC and the FDIC restructuring was given from all sources, we were surprised, to say the least, when 24 hours before the plan was sent to Congress it was announced that we were involved and were included. I understand that. I don't have to like it, but we accept it, and we will deal with it.

But I would say, Mr. Chairman, that there have been many facts that have been put out as facts, statements that have been made as facts, that have been very misleading, and the fact that one of them that is most prominent is that this is just a teeny-weeny minor, little accounting change that they are making in the structure of the National Credit Union Share Insurance Fund.

This teeny weeny minor accounting change will devastate the Fund, will bring it to its knees, and I don't believe that those who advocate it are doing so for any adverse reasons, but they are doing it because they have been either misled, misinformed, or they do not have all the facts.

So, I would be pleased to respond to any questions that anyone may have with regard to the National Credit Union Share Insurance Fund.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Well, thank you, Mr. Jepsen.

You note in your testimony that approximately \$2 billion exists in your insurance fund, and that these moneys count to offset the Federal deficit.

As you know, several trust funds are counted as a reduction to the Federal deficit such as the Social Security Trust Fund.

As a matter of principle, do you think it is sound financial practice for the Federal Government to count specially allocated trust funds as an offset to the deficit?

Mr. JEPSEN. I believe if I recall correctly that this is considered to be an off-off-budget-type of approach, and the history of counting these to offset the deficit has been put together by folks that have a huge responsibility to try to bring spending in line with income and the use of various funds to offset the deficit is something that I think should have a lot of studying.

I am not answering your question. I learned how to do that in the U.S. Senate. [Laughter.]

Chairman ROSTENKOWSKI. Well, are you suspicious that maybe this off-budget item is so that the deficit won't look any larger?

Mr. JEPSEN. Oh, I'm sure that's true.

Chairman ROSTENKOWSKI. Do you think that that's a compromise because of our foreign investors? Do you think that maybe this is the first time that we in Government are going to try to make our deficit look not as large as it really is only because we discourage our foreign investors from spending dollars here?

This is a new twist, as I view it, with respect to how we are viewing the deficit that we have, and I'm just wondering whether this isn't the first step in what might be viewed as the wrong direction because now we are really catering to the dollars that are invested here in this country, and we're doing it with more mirrors and smoke.

Mr. McGRATH. Will the chairman yield?

Mr. JEPSEN. I heard your statement.

Mr. McGRATH. Mr. Chairman, would you yield on that point?

Chairman ROSTENKOWSKI. Sure.

Mr. McGRATH. If we were to adapt the credit union mechanism for insuring deposits to other financial institutions—you have stated that there's \$2 billion of deficit offset there—what might the numbers be? What would be the potential effect on the deficit?

Do you have any idea if we took the commercial banks and the savings, or thrifts, and plugged in this particular 1 percent of deposits as an insurance fund, what the effect on the deficit would be?

Mr. JEPSEN. Well, if I understand your question, Congressman, what if the other funds were patterned after ours, and under the present arrangement for accounting for the funds against the Federal deficit?

Mr. McGRATH. That's correct.

Mr. JEPSEN. We have done the arithmetic on that, and if the other funds were capitalized and were put together in the same form as the National Credit Union Share Insurance Fund, it would result today in about a \$27 billion reduction in the Federal deficit.

Mr. McGRATH. Thank you.

Chairman ROSTENKOWSKI. Mr. Jepsen, could you give us some information regarding the magnitude of recent credit union insolvencies? If you can't do that today, could you supply that for the record?

Mr. JEPSEN. I would ask Mr. Riley to respond to that.

Mr. RILEY. The magnitude of credit union insolvencies, the condition, we increased a small amount in 1986, 1987. At the end of 1988, we had about 6 percent of our credit unions were coded, a code 4 or 5; it doesn't mean they are insolvent.

We have about, I would say, 26 credit unions right now that are receiving either direct or indirect assistance from the Share Insurance Fund.

We think part of the increase in credit unions, it's still only 6 percent of all total shares outstanding have some type of problem associated with them. We think the primary reason for the small increase, about a percent increase over the last 3 years, has been, we have had more examiners, we have had better training, we actually have a little bit better rating system now.

So, we are pleased in the fact that at least during the time period of the last few years where banks and savings and loans have had pretty strong problems, that in 1988, we had the fewest

number of assisted mergers or liquidations that we have ever had in our history.

So, in terms of overall insolvency, we are probably in the best shape we have been in several years.

Chairman ROSTENKOWSKI. Mr. Archer?

Mr. ARCHER. Thank you, Mr. Chairman.

When you speak, Senator Jepsen, of the 1.26 percent, is that a percent of total outstanding loans, or did I understand you correctly that that is a percent of capital?

Mr. JEPSEN. The 1.26 percent is the figure that reflects for every \$100 of insured shares at risk we have \$1.26 in the fund.

Mr. ARCHER. Well, when you say insured shares at risk, does that mean what we, in layman's terms, call loans?

Mr. RILEY. No, that would be a deposit—in a bank, it would be deposits in a bank. We have—right now we have \$175 billion worth of share deposits in the credit unions.

Mr. ARCHER. And what percent of that is normally out on loan?

Mr. RILEY. Right now about 71 percent is in loans.

Mr. ARCHER. OK.

So that actually would be an even bigger percentage compared to the amount of outstanding at risk loans?

Mr. RILEY. Yes.

Mr. JEPSEN. Yes, it is.

Mr. ARCHER. All right.

How does that compare to what the reserves have been in the FSLIC and the FDIC prior to the problem times coming?

Mr. JEPSEN. Part of this will be for memory—

Mr. ARCHER. As a percent of outstanding loans?

Mr. JEPSEN. I would have to provide that for the record.

Normally speaking, the credit unions have been traditionally consumer lenders. The activities that a bank and an S&L is normally not the same as the credit unions. In the—

Mr. ARCHER. Yes, I am aware of that, but I still was—

Mr. JEPSEN. The last balance sheets that I saw of an S&L reflected primarily real estate and mortgage type loans, and they had a percentage higher than 70 percent. They were usually within the 90 percent range.

Mr. ARCHER. But their reserves they put aside at the time that everything was running along pretty well in this country, before we got into the 1980's? What percent had those reserves built up to as a percent of loans in the FSLIC and the FDIC? Do you have any rough idea of that?

Mr. JEPSEN. At least in the late 1970's and early 1980's I would say the—at least the capital requirements in the S&L's was about 6 or 5 percent.

Mr. ARCHER. No, I am not talking about capital. I am talking about the reserves in the FSLIC and the reserves in the FDIC as a percent of aggregate outstanding loans?

Mr. JEPSEN. Well, I would have to supply that for the record. I only know what the FDIC—

Mr. ARCHER. I do not want you to say something off the top of your head that is not accurate, but can you give me a ballpark guess as we sit here now and supply the accurate figures for the record?

Mr. JEPSEN. I can give you—the FDIC's equity ratio has been in the range before the last few years about 1.3 or so. They have had, I would guess, about 50 percent of a bank's assets in loans. I cannot do the math, but essentially, for most of the time period that we are talking about the bank's reserving and the FDIC's reserving were very similar to ours.

In our opinion, FSLIC has been severely unreserved for a number of years.

Mr. ARCHER. OK.

Well, when you say fail-safe, Senator, I am sure that your experience has been very good. I think that is commendable and is to be applauded to the credit unions. If our economy went into a significant recession then would not consumer loans also be very vulnerable? If so, would your fail-safe guarantee still hold valid?

Mr. JEPSEN. Yes, it would because the Fund always has to maintain this 1 percent ratio, and it is not directly tied, as has been pointed out here in the last few minutes to the loan portfolio, but it is tied to the total amount of shares, shares is the credit union's community word for deposit.

So a slowdown in the economy and a backing off of consumer loans would rather pose some problems. It would not have a devastating on the Fund because the Fund is based, again, on the 1 percent of the shares that are on deposit.

The insurance has to be separated and looked at as a combination of participation by the credit unions and a participation by the regulatory agency that, with accountability on both sides, there is a thread of ownership that works very successfully. We feel that any financial institution, which relies on insurance funds should be responsible for maintaining that fund.

That thought and that practice is built into this formula which is very key to its successful, virtually fail-safe operation.

Mr. ARCHER. What is the average length of the loans nationwide in the credit unions? Do you have information on that?

Mr. JEPSEN. Mr. Riley is director of our insurance fund and our education trainer of our examiners, and he will answer that.

Mr. RILEY. The average length of the loan in the credit union—we measure it by land turnover—how quickly it has been paid—it has been running about 18 months.

Mr. ARCHER. About 18 months?

Mr. RILEY. Yes, I would guess.

Mr. ARCHER. Are you audited by any arm of the Federal Government or is all of your auditing done internally within your organizations?

Mr. RILEY. We are audited by GAO. We have a clean opinion. We are audited by Price Waterhouse, the only one of the three deposit funds that goes outside to get an independent CPA firm to audit.

Mr. ARCHER. Are you subject to regulatory restrictions by Federal law as to what percent of loans have to be in any particular category or what is authorized as a qualified loan?

Mr. JEPSEN. I will ask our general counsel to respond to that.

Mr. FENNER. Of course, first of all credit unions are permitted to make loans only to their members.

Mr. ARCHER. I understand that.

Mr. FENNER. They are authorized within those limits to make it a pretty broad range of loans, consumer loans, home mortgage loans, credit card loans. The only lending authority that is restricted in terms of percentage is the authority to make business loans to their members—loans for business purposes, and we have a regulation in place that requires that each credit union that ventures into area of lending set limits and develop a plan, and so forth.

Mr. ARCHER. Thank you very much.

Mr. GIBBONS [presiding]. Mr. Stark? Mr. Pease? Mr. Moody? Mr. McGrath?

Mr. McGRATH. Mr. Chairman, thank you.

Only one further question. In the 1986 bill we reduced or made an attempt to eliminate the deductibility of consumer interest, and I am wondering what kind of effect that has had on the number of loans and the amount of loans that the credit unions make?

Mr. JEPSEN. I think, Congressman, the effect has been similar to other financial institutions. That law caused many folks to do some financial planning as is always the case when you change the tax laws, one for those who plan and one for those who do not. When the deduction of the interest on your consumer-type loans started to be and reduced each and every year, they found out with proper planning that you go to home equity loans so that you can provide for 100 percent deduction.

Both individuals and corporations, businesses throughout the history of our country seem to make and plan around those things that Congress changes. Therefore, there has been some increase in home equity loans in the credit union community.

By the same token, and thank goodness, the trends which took a dip in 1985 and 1986 in our consumer loans—it dipped downward—we had a combination of rapid growth in the reduction in consumer loans, has now reversed itself and is heading back up. We feel the best investment is a loan to a member, and that is very basic in credit unions. I think it is very basic anywhere.

But that is heading in the right direction.

Mr. McGRATH. Thank you, Senator.

Thank you, Mr. Chairman.

Mr. GIBBONS. Thank you. Let's see. Mr. Coyne? All right.

Mr. COYNE. No questions.

Mr. GIBBONS. All right.

Mr. Levin?

Levin is not here. Mr. Chandler?

[No response.]

Mr. GIBBONS. Mr. Sundquist?

Mr. SUNDQUIST. No questions, Mr. Chairman.

Mr. GIBBONS. Mrs. Johnson?

Mrs. JOHNSON. No questions, Mr. Chairman.

Mr. GIBBONS. I just had a couple of members ask me to ask their questions, Senator. I am not really familiar with your organization nor are they. How many members are there on your board?

Mr. JEPSEN. We have—on the NCUA board?

Mr. GIBBONS. Yes, sir.

Mr. JEPSEN. We have three members, Congressman.

Mr. GIBBONS. I assume that you are appointed by the President, is that right?

Mr. JEPSEN. We are appointed by the President, confirmed by the Senate, and the statute provides for a one full 6-year term, and it is limited to one full 6-year term.

Mr. GIBBONS. And you are staggered on the board, is that right?

Mr. JEPSEN. In your terms, we are staggered on the board, yes, sir.

Mr. GIBBONS. All right.

Mrs. JOHNSON. Mr. Chairman, I do have one question that I would like to ask. It is not directly related to your testimony, but is of great concern to me, and I have discussed it with my credit unions.

I am concerned about organizations like AARP developing a credit union. It seems to me fundamentally antagonistic to the concept of credit unions as they have functioned historically in our society. I wonder if your board has given any thought to this issue of definition since credit unions in the past have been unique by the nature of the relationship between the credit unions and their members.

It seems to me AARP and its membership do not have the same relationship that credit unions have had traditionally, and I wonder if you are looking at this matter because it is very important from the point of view of regulation. If credit unions begin to look differently—begin to look like other animals they would also have to be treated like other animals.

Mr. JEPSEN. I thank you for that question, and we share your concern, and we have gone to the drawing board and are in the process, and will be approving a completely new manual—it will not be necessarily new material in it, but with regard to chartering and fields of membership it represents a new effort.

Because of deregulation and because of the rapid swing in interest rates, and everything that has been taking place in the financial institutions in the last 8 to 10 years—we are doing everything we can to make sure that this concept, common bond, and truly serving on a direct basis people-before-dollars philosophy be maintained.

We are studying this, and I would refer you to the general counsel for any additional comments on that.

Mr. FENNER. Well, just a couple of points.

The AARP Federal Credit Union, of course, technically is not a part of the AARP sponsoring organization, but is set up as an associational credit union to serve members of AARP. That is the type of credit union that is provided for under the Federal Credit Union Act, and I am satisfied that it is a perfectly legal charter.

Under the new field of membership and chartering guidelines that we are looking at, if the NCUA board approves them, there will be an emphasis in the future on chartering these types of associational credit unions on a more local and regional basis.

Mrs. JOHNSON. Thank you.

I believe that if that is the direction the industry is going to take, I think you will have to look at it differently, and we will have to look at it differently because the checks and balances that are relied upon in credit unions that are very local and close to their memberships simply are not going to function the same way.

I, for one, understand that the AARP Credit Union is perfectly legal, but I do not think it is harmonious with the history of credit unions. I think it raises very serious questions that in the next couple of years we are going to have to answer.

Mr. FENNER. If I could just clarify and emphasize one point in my response.

If the board approves the new chartering guidelines that the staff has developed, then the direction that we are headed in is to charter associational credit unions, again, on a more local and regional basis. That type of charter application might have been viewed differently under the new guidelines that we are looking at.

Mrs. JOHNSON. But has it been reviewed and accepted at this point?

Mr. FENNER. Yes, ma'am.

Mrs. JOHNSON. Thank you.

Chairman ROSTENKOWSKI. Mr. Chandler?

Mr. CHANDLER. Mr. Chairman, just one brief question or comment.

I certainly agree with the point made by my colleague from Connecticut. When you have a creature out there acting like a bank and competing with banks but doing so at a very highly favorable taxation treatment and regulatory treatment—I think that is hard to justify. We all understand what the credit union was intended to be and why it was set up.

Just a question on the problem with S&L's. We know geographically it has been primarily a California, Florida, and Texas problem, but especially Texas. Have any of the problems with credit unions been regional? For example, Texas? What is the history of credit unions in that State?

Mr. JEPSEN. Mr. Riley will respond to that.

Mr. RILEY. We have been—just in Texas alone, just to compare what happened to the S&L's and banks and credit unions just looking at one, the solvency ratio in Texas.

In 1986, the average solvency ratio in Texas for S&L's was a negative 16 percent, for banks, it was 4.4 percent, for credit unions it was 5.3 percent. If we look at 1988 the S&L's have grown to a 35 percent insolvency, banks are at 1.7, and credit unions were still at 5.2 percent.

Because we are smaller institutions not involved in many of the things that the larger institutions were involved in, we, in a really bad economy in Texas have seemed to have done very well.

Chairman ROSTENKOWSKI. Thank you, Mr. Jespen. Thank you very much for joining us this morning.

Mr. JEPSEN. Thank you.

Chairman ROSTENKOWSKI. Gentlemen, thank you very much.

Mr. JEPSEN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Ms. Owens? Mr. Engelke? Mr. Rideout?

Ladies and gentlemen, welcome to the committee. You all know what the procedure is here. We will ask you each to testify for your allotted time, and then we will ask questions. Each member is entitled to 5 minutes of questioning.

If there is something that you would like to add, after you have concluded your testimony to what another person has said, or make a suggestion, please feel free to do so.

In your opening statements, I would like you to identify the association that you are with, and Mr. Rideout, we will begin with you, and then Ms. Owens, and then Mr. Engelke. Mr. Rideout.

STATEMENT OF THOMAS P. RIDEOUT, PRESIDENT, AMERICAN BANKERS ASSOCIATION (VICE CHAIRMAN, FIRST UNION NATIONAL BANK OF NORTH CAROLINA, CHARLOTTE, N.C.)

Mr. RIDEOUT. Thank you, Mr. Chairman. Mr. Chairman, members of the committee, my name is Thomas P. Rideout. I am vice chairman of the First Union National Bank of North Carolina, and president of the American Bankers Association.

I appreciate the opportunity to present the views of the American Bankers Association on the critical issues surrounding the savings and loan crisis.

The FSLIC insolvency is largely the result of inadequate Federal Home Loan Bank Board regulation and supervision. The Bush administration plan provides much needed funding for case resolution. It also addresses inadequate thrift regulation in a comprehensive manner. Therefore, the ABA has agreed to support and work actively for President Bush's proposed plan to solve the savings and loan crisis.

There has been a lot of comment about whether the FSLIC bailout should be entirely on budget as recommended by the Ways and Means Committee, or whether it should be on budget for interest only, and off budget with respect to principal.

This issue involves consideration of cost, both short-term and long-term, and political judgment. The ABA believes very strongly, that the FSLIC crisis needs to be addressed by Congress as quickly as possible.

We cannot stop the mounting cost of the problem, estimated at \$40 million per day, until Congress provides the Federal authorities with sufficient funds to close down the insolvent savings and loans.

Therefore, we are concerned that an extensive congressional debate about the FSLIC bailout vis-a-vis the Gramm-Rudman-Hollings targets, might delay the resolution of the issue.

If, however, the Congress can conclude quickly, that this matter should be on budget, the ABA would not oppose that result.

Last year, ABA's FSLIC Oversight Committee urged the Congress to extend the tax provisions for thrift acquisitions beyond December 31, 1988 in order to allow FSLIC to resolve more cases.

The ABA believed that quick action to close down the insolvent institutions was, and continues to be the highest priority. Utilizing the tax benefits in these transactions served to augment the otherwise depleted resources of the FSLIC insurance fund.

As the Ways and Means Committee considers whether to extend the provisions beyond the end of 1989, we believe the key consideration should be the adequacy of the savings and loan industry rescue plan to be enacted by Congress.

A fully funded plan to close the insolvent savings and loans would eliminate the need to use special tax provisions as a source of funds for the rescue.

We see no other rationale underlying these expiring provisions.

The committee's review of the sections of the code that provide special benefits to the savings and loan industry affords an excellent opportunity to move toward functional taxation of financial institutions.

By using the term "functional taxation," I suggest that the tax incentive should follow the financing instrument rather than the charter of the institution.

Specifically, we recommend that a tax credit be developed for housing finance, an amount that would be revenue-neutral as compared with the present annual revenue loss of section 593, and that would be available to all lenders on a proportional basis.

The current statute actually may encourage an S&L to reduce its qualifying assets down to 60 percent. Under a proportional tax incentive system, an S&L with 60 percent of its assets in mortgages would get twice as much credit as a commercial bank of the same size with 30 percent of its assets in mortgages.

As each institution increased its proportion of mortgages each would get the same additional credit. Such a revision would be a clear boost to housing in this country, and, at the same time would make the code more equitable by providing for functional taxation of all mortgage lenders.

While this hearing is devoted to the savings and loan industry crisis, we believe it is appropriate to recommend another major step towards the functional taxation of financial institutions. Taxation of credit unions.

This was recommended by both the Carter and Reagan administrations, and by the Congressional Budget Office. The tax exemption for these institutions constitutes one of the largest tax expenditures in the financial institution provisions of the code, and is a slap in the face of fair taxation.

Mr. Chairman, the previous credit union witness testified correctly to the soundness of the Credit Union Insurance Fund. However, credit unions are using phony accounting to reflect the special and ongoing 1 percent on deposits contribution to the fund.

They have written the check but they have not deducted it from their checkbook. Their assets are overstated by this amount, as is their capital. The Bush plan will correct this flagrant accounting treatment over time, and we endorse that provision, in particular, of the bill.

Thank you for this opportunity to present our views.

[The statement of Mr. Rideout follows:]

Statement of
Thomas P. Rideout

Vice Chairman
First Union National Bank of North Carolina
Charlotte, North Carolina

President
American Bankers Association

Before the
Committee on Ways & Means
United States House of Representatives

March 9, 1989

I. INTRODUCTION

Mr. Chairman and members of the Committee, my name is Thomas P. Rideout. I am Vice Chairman of the First Union National Bank of North Carolina, and President of the American Bankers Association. I appreciate the opportunity to appear before your Committee today to present the views of the American Bankers Association on the critical issues surrounding the savings and loan industry and its insuring agency, the Federal Savings and Loan Insurance Corporation (FSLIC).

The American Bankers Association (ABA) membership ranges in size from the smallest to the very largest banks, with 85% of our members having assets of less than \$100 million. The combined assets of our members comprise about 95% of the total assets of the commercial banking industry.

This Committee's action to conduct a thorough examination of the financial condition of the FSLIC and the savings & loan (S&L) industry is both timely and important. We hope our testimony will help the Committee appreciate the dimension of the problem and the need for a comprehensive solution.

Last year, the American Bankers Association established a FSLIC Oversight Committee to both monitor the FSLIC situation and to provide a continuing forum for discussion of the issues. This Committee has prepared two policy research papers, reflecting its deliberations. The first paper, released in September 1988, outlines the issues and establishes guidelines for resolving the S&L crisis. The second paper recommends specific regulatory reforms which we believe must be a part of any comprehensive resolution. My testimony draws heavily on the expertise of this Committee.

During their deliberations, the Committee developed a set of principles against which to evaluate proposed solutions to the S&L crisis. Underlying these principles are three key points which have become the backbone of ABA's position.

1. Insolvent savings & loans must either be closed or merged quickly. Merged institutions must have adequate capital to ensure that the new entity stands a good chance of success.
2. Savings institutions must be subject to bank-like regulation and supervision.
3. The resources of the FDIC and the banking industry should not be used to bail out the savings and loan industry.

With these principles in mind, the American Bankers Association applauds the prompt and decisive action the new Administration is taking to address the FSLIC crisis. The Administration's plan imposes hardships on all of us, but we are in the midst of a financial emergency -- we need prompt action. The plan proposed by the Administration will get the case resolution process underway and halt the financial bleeding.

A. Cause and Size of the FSLIC Insolvency

The FSLIC insolvency is largely the result of inadequate Federal Home Loan Bank Board (FHLBB) regulation and supervision. Heavy reliance on fixed-rate mortgages has always made savings & loan institutions vulnerable to volatile interest rates. As interest rates rose in the late 1970s and early 1980s, the market value of savings & loan institution mortgage portfolios plummeted. At the interest rate peak in 1981, savings & loan institutions were insolvent on a market value basis by perhaps as much as \$100 billion.

Believing the troubles of the savings & loan to be a temporary result of high interest rates, the FHLBB and Congress gave their approval to a variety of forbearance and regulatory accounting procedures which masked the insolvency of these institutions. However, these measures -- including net worth certificates, deferred losses on asset sales, favorable accounting treatment and tax benefits in acquisitions of failing institutions -- offered only a cosmetic solution.

The loosening of accounting standards created a situation which allowed savings & loans with little or no true net worth to continue to operate. Many of these FSLIC-insured savings & loans, in an effort to increase their profitability, had strong incentives to take on high-risk assets seeking higher returns. There are numerous reported cases of financing of real estate projects that were never built and land loans based upon inflated appraisals. Some FSLIC-insured savings & loans gambled on swings in interest rates by purposely taking excessive mismatched asset and liability positions. Still other insolvent or weak institutions resorted to rapid deposit growth as a way to pay personnel and other operating expenses.

While no system of regulation and supervision is able to prevent all unsafe and unsound practices or detect all fraud and insider abuse, the considered judgment of the ABA is that the failure of the FHLBB to adequately supervise and regulate the savings & loan industry contributed materially to its insolvency. It is in error to think that deregulation of deposit interest rates and the related expansion of savings & loan powers in the early 1980s caused the FSLIC's insolvency. The weakness that condemned the FSLIC to insolvency was the FHLBB's failure to strengthen its examination and supervisory policies and personnel to handle the rapidly growing portfolios of FSLIC-insured savings & loans. Equally important, the FHLBB failed to close down institutions promptly once they were recognized as insolvent. Rather, these insolvent savings & loans continued to operate in a way that only worsened their financial condition and imposed additional losses on the FSLIC.

The depth of the FSLIC's insolvency has been repeatedly and seriously underestimated. There was an emerging recognition of an "FSLIC problem" during 1985. At that time, it was thought that the problem could be resolved in a few years with the use of special insurance assessments. By early 1986, the FSLIC problem worsened to the point where the special assessment was seen as a burden that the industry would likely have to endure for a least five years; additional funds beyond the special assessment would also be needed. In mid-year 1987 the Congress authorized additional funds through the recapitalization program, but by the time the legislation was passed the problem had deteriorated to the point where the recapitalization was widely viewed as being only a temporary palliative.

By year-end 1987, the insolvency of the FSLIC was estimated to be in the range of \$30 billion to \$60 billion. The magnitude of the FSLIC's insolvency has continued to grow in 1988 at a dramatic pace. Based upon the liquidation experience for the first half of 1988, the ABA FSLIC Oversight Committee estimated that the FSLIC's net worth at mid-year was a negative \$74 billion. Since that time official estimates by the Administration, the General Accounting Office and the Congressional Budget Office have matched or exceeded that number.

This grim condition comes at a time when the U.S. economy in general would be regarded as favorable to the savings & loan industry. Less favorable economic and financial market trends, including rising interest rates which are already occurring, could bring an even greater disaster to the savings & loan industry. The importance of these economic trends cannot be minimized. Nonetheless, a greater threat to the health of all depository

institutions is the continued operation of insolvent or nearly-insolvent FSLIC-insured savings & loans.

B. ABA Position on Administration Plan

The Administration's plan is contained in H.R. 1278 and S. 413, the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA). The broad parameters of this legislation were carefully weighed by the ABA's Banking Leadership Conference last week. This group consists of the ABA's leadership and delegates, state banking association executives, and leaders of other bank trade associations -- over 400 bankers in all. After careful deliberation, we agreed to support, and work actively for, President Bush's proposed plan to solve the savings and loan crisis.

The Administration plan will have a direct long-term impact not only on the savings & loan industry, but on the banking industry as well. The banking industry has for years been heavily impacted by competing with a savings & loan industry which has been poorly regulated and which has therefore operated in an unsafe and unsound manner. The ABA believes a comprehensive approach is absolutely vital to the development of a permanent resolution to the savings & loan crisis. The widespread insolvencies in the S&L industry are the result of a complex set of circumstances, and it is clear that the problems cannot be solved by a simple recapitalization of the FSLIC. We are pleased, therefore, that the Administration plan looks beyond the immediate financial dimensions of the FSLIC's insolvency to focus on the structural deficiencies which allowed the crisis to develop and fester.

Bank Earnings Impact

Mr. Chairman, I emphasize that the ABA supports H.R. 1278 even though we recognize that it will have a severe negative impact on the profitability of our industry. The proposed increases in FDIC insurance premiums will almost double the current statutory premium level and more than quadruple the level of premiums actually paid by banks just a few years ago. And while a premium increase of 7 cents per 100 dollars may not sound like much, it is large in relation to the narrow spreads in the banking industry. In a good year, an average bank may earn 70 cents per 100 dollars on assets -- in this context, a 7 cents per 100 dollars increase in expense is clearly quite significant.

The proposed increase in premiums will also add to already high regulatory costs, further undermining banks' competitive position vis-a-vis nonbank financial firms who offer bank-like services but are not subject to the same regulatory and supervisory costs. The proposed increase in deposit insurance cost also undermines U.S. banks' ability to compete with foreign institutions who do not have the same regulatory costs. It is no coincidence that U.S. banks have fallen from their leadership position in world financial markets. Out dated laws and heavy regulatory costs have seriously eroded the competitive position of U.S. banks.

S&L Regulatory Reform

The ABA fully supports the regulatory reforms in H.R. 1278 to revamp the structure of the regulatory agencies, including putting the new Federal Home Loan Bank System under the Treasury Department in a manner comparable to the Comptroller of the Currency. We recognize that this proposal is controversial; however, the history of inadequate regulation by the Federal Home Loan Bank Board must be considered. We believe that putting the Federal Home Loan Bank System under the Treasury is necessary to ensure that S&L regulators are held accountable for their actions and to reassure the public that the coziness between regulator and industry will not occur again.

We also support the effort to apply bank-like regulatory requirements to the S&L industry, particularly in the area of capital standards. We are opposed to the efforts of the S&L industry to lengthen the phase-in period for complying with these capital standards. S&L officials argue that the phase-in of bank-like capital requirements is too short. Keep in mind that banks are complying with those standards now, and undercapitalized banks are being brought up to those standards with no phase-in. Moreover, the banking industry is being required to greatly increase its capital during roughly the same period to comply with the new international Basle agreement. If we can comply, so can the savings & loans.

There is, in our opinion, a misconception that hundreds of savings & loans will not be able to comply with this standard, and therefore will either disappear or fail, increasing the costs of resolving the S&L crisis. This is not the case. All the plan says is that S&Ls that do not meet the capital standards cannot grow. Growth without adequate capital will increase the cost of the FSLIC rescue package. As is true for banks that have capital problems, the regulators can work with individual S&Ls to design programs to enable them to come into compliance with the required capital ratios. Such programs include cutting costs, curtailing dividends, selling certain assets, and, if these measures do not work, merger with a healthy institution.

Failure to impose adequate capital requirements on the S&L industry is one of the major causes of the hundred billion dollar problem we now face. It will be tragically ironic if the S&L industry once again convinces the Congress to grant forbearance in the area of adequate capital.

My testimony before the Senate Banking Committee, presented just yesterday, elaborates on these points and many other important aspects of the Administration plan. We will provide a copy of that testimony to the Committee for its use.

II. TAX AND BUDGET ISSUES RELATED TO THE FSLIC INSOLVENCY

Budget Treatment of FSLIC Bailout

There has been a lot of comment, analysis and posturing about whether the FSLIC bailout should be entirely on-budget as recommended by the Ways & Means Committee or whether it should be on-budget for interest only and off-budget with respect to principal. This issue involves consideration of cost, both short term and long term, and political judgment. The CBO estimates that use of a separate entity for the purposes of achieving off-budget treatment of savings & loan resolution costs would increase the cost of the bailout finance by \$100 million to \$200 million each year over the next 30 years, depending on the spread in interest rates.

A potential cost to an on-budget approach is an adverse market reaction to a decision to amend the Gramm-Rudman-Hollings budget target in order to cover the cost of the bailout. The market may have already factored in the cost of the FSLIC bailout, but a decision to amend the Gramm-Rudman-Hollings targets for this issue raises the specter that it might be done again for another crisis and reflect a lack of commitment to reduce the budget deficit. This potential cost should be explored before it is assumed that on-budget financing is automatically the least expensive approach to the FSLIC crisis.

The question of political judgment is an even more intangible consideration. The ABA believes very strongly that the FSLIC crisis needs to be addressed by Congress as quickly as possible. We cannot stop the mounting cost of the problem until Congress provides the federal authorities with sufficient funds to close down the insolvent savings & loans. Therefore, we are concerned that an extensive Congressional debate about the FSLIC bailout vis-a-vis the Gramm-Rudman-Hollings targets might delay the resolution of the issue. If, however, the Congress can conclude quickly that this matter should be on-budget, the ABA would not oppose that result. After all, regulatory forbearance and other devices designed to conceal the true financial condition of savings & loan institutions is what got them into trouble in the first place. We certainly would not want to advocate a similar tactic for the savings & loan resolution process, if the Congress makes the political judgment quickly.

Acquisitions of Thrifts

An important part of H.R. 1278 is the creation of a Resolution Trust Corporation (RTC) to assume responsibility for managing the sale, merger or liquidation of all insolvent savings & loans. We strongly support giving the RTC authority to limit asset growth and asset acquisitions, lending activities, use of brokered deposits, and interest rates payable on deposits at institutions under its jurisdiction.

Equally important, those savings & loans which are merged or sold must be adequately capitalized so that they have a reasonable chance for success, and to assure that they will not have an unfair competitive advantage over fully capitalized institutions. There have been concerns raised that perhaps some of the savings & loans which were "recapitalized" over the past few months do not in fact have enough real capital to meet these criteria. We therefore support the proposal to authorize the RTC to review and, where appropriate, restructure the FSLIC's 1988 case resolution agreements. We encourage the Administration and Congress to insist that future S&L sales result in institutions which are fully capitalized, no longer dependent on government support, and not privileged by special concessions.

Allowing bank holding companies to acquire S&Ls would provide a much needed injection of capital -- as well as management expertise -- into the savings and loan industry. Under current law bank holding companies are only permitted to acquire insolvent savings and loans. We fully support the provision of H.R. 1278 which would allow bank holding companies to acquire healthy savings & loans in two years, although we would prefer to see that time period shortened or eliminated. We urge that Congress also consider allowing immediate acquisition by bank holding companies of savings and loan institutions which are still solvent, but are thinly capitalized. All acquisitions should be permitted on the same terms as would be applied to nonbank institutions which acquire an S&L. Taking steps to make acquisition of S&Ls financially attractive to banks and bank holding companies would contribute substantially to the resolution of the S&L crisis. Such an approach could save the government a considerable amount of money.

Tax Treatment of Acquisitions of Financially Troubled Thrifts

Since 1981, the tax code has contained three special provisions which provide relief for assisted acquisitions of failing savings & loan institutions by: (1) excluding from income the FSLIC assistance; (2) permitting tax free reorganization for the acquisition; and (3) relaxing the net operating loss carryover rules. Last year the Congress extended these provisions for one year with two important changes. Congress curtailed the tax benefits by requiring a reduction in the tax attributes equal to 50% of the FSLIC contribution. For the first time the Congress extended the same rules to FDIC assisted acquisitions of failing commercial banks. All of these provisions are scheduled to expire on January 1, 1990.

Last year ABA's FSLIC Oversight Committee urged the Congress to extend the FSLIC provisions beyond 12/31/88 in order to allow FSLIC to resolve more insolvent savings & loan cases, at a faster pace, than if the law had been allowed to expire. The ABA believed that quick action to close down the insolvent institutions was, and continues to be, the highest priority. Utilizing the tax benefits in these transactions served to augment the otherwise depleted resources of the FSLIC insurance fund. We accepted at face value the argument that these benefits would have the affect of reducing the direct outlays or obligations of the FSLIC and thereby save insurance fund resources. As the Ways and Means Committee considers whether to extend the provisions beyond the end of 1989, we believe the key consideration should be the adequacy of the savings & loan industry rescue plan to be enacted by Congress. A fully funded plan to close the insolvent savings & loans would eliminate the need to use special tax provisions as a source of funds for the rescue. We see no other rationale underlying these expiring provisions.

Two additional comments are appropriate. First, we strongly recommend that the Congress keep the treatment of FDIC and FSLIC transactions equal. There is no valid tax policy rationale for going back to the pre-1989 situation where the acquisition of a failing savings & loan was more attractive taxwise than acquisition of a failing bank. Second, if both the FDIC and FSLIC provisions are allowed to expire, it would be appropriate for IRS to issue guidance on the tax treatment of the transactions in the absence of the special provisions. Such guidance would provide certainty as to the tax issues, and in this respect assist in the bidding for insolvent institutions. Rulings with respect to FDIC assisted transactions prior to 1989 do not provide clear guidance concerning the taxation of such acquisitions.

Housing Finance Issues

The S&L industry has in the past been an important source of home financing, although recently the extent of the role of S&Ls has been questioned. During the public debate on the FSLIC crisis, some have raised concerns that the proposed regulatory reforms will somehow reduce the availability of home mortgages, and that home buyers will have to pay higher rates to get financing. We believe these fears are unfounded.

There is nothing in H.R. 1278 that reduces the ability of savings and loans to provide mortgage financing. In fact, the regulatory reforms proposed by the bill will strengthen the savings and loan industry, putting it in a better position to participate in mortgage lending both directly through portfolio holdings and indirectly through the secondary market.

In designing the proper structure of the S&L industry, however, it is important to understand the tremendous changes that are taking place in housing finance. Significant innovations have evolved in recent years which have fundamentally transformed the mortgage market. At the heart of this transformation is securitization -- the pooling of similar types of small loans to be used as collateral for issuance of a security. Residential mortgages have proven to be well suited to this process, and have led the way in asset securitization.

This increasing use of securities markets to fund residential mortgages will reduce the reliance on both banks and savings & loans as primary mortgage lenders. Moreover, funding mortgages in the securities markets through the securitization process reduces the cost of borrowing for two reasons. First, the intermediation cost of raising funds through securities markets is lower than the cost of traditional bank and S&L intermediation. Second, debt securities appeal to a broader pool of potential funds suppliers than do traditional loan instruments. This broader appeal means that life insurance companies, pension funds, and even foreign investors are holding a much larger share of mortgage loans outstanding than was the case a decade ago. And the larger the pool of potential investors, the lower the cost to the borrower.

Securitization is increasingly important in facilitating home mortgage lending. Mortgage-backed securities as a percent of total mortgages outstanding grew from about 5 percent in 1975 to over 33 percent by 1988. An estimated 70-80 percent of the \$444.5 billion of residential mortgage loans originated in the 12 month period September 1987 - September 1988 were securitized.

Functional Tax Incentives for Mortgage Lending

The Committee's review of the sections of the Code that provide special benefits to the savings and loan industry affords an excellent opportunity to move toward functional taxation of financial institutions. By using the term "functional taxation" I mean that the taxation of a financial institution should be the same whether that institution is a commercial bank, or a savings and loan, or a credit union. Last year the Congress took an important first step toward functional taxation when it applied the same tax rules to FSLIC and FDIC assisted acquisitions of failing institutions. Now the Committee can continue that process by applying the identical tax provisions that encourage housing finance to both banks and savings & loans. This change could be made on a revenue neutral basis, in proportion to each institution's amount of housing finance, and in a way that encourages incremental housing finance by all types of lenders. The development of the secondary mortgage market, described above, underscores the rationale for this revision of the tax provisions on housing finance.

Section 593 of the Code provides a bad debt reserve deduction which far exceeds actual loss experience for savings & loans institutions which hold 60 percent of qualifying assets. The Blue Book for the Tax Reform Act of 1986 states that this provision is intended as an incentive for savings & loan institutions to provide residential mortgage loans. In spite of this provision, savings and loans have reduced their residential mortgage obligations. In 1974, thrifts (both S&Ls and mutual savings banks) devoted 70.8% of their assets to direct holdings of residential mortgage loans, but in 1987 that number had dropped to 46.4%. Similarly, in 1974 thrifts held about 53% of all the mortgages in the U.S., but that number has fallen steadily to 32.1% in 1987.

Testimony before the Economic Stabilization Subcommittee of the House Banking Committee on May 9, 1985 by the National Council of Savings Institutions revealed very clearly their agenda is to keep their tax bills low, not keep their direct lending to housing high. At that time, John Tucillo, Vice President and Director of Research and Economics for NCSI stated,

"The importance of the bad debt allowance as a prime tool for reducing tax burdens has trapped the savings & loans into what is essentially a single investment portfolio that has proven unprofitable. The tradeoff of this preference for a lower corporate tax rate will allow savings institutions to make their investment decisions on economic and financial rather than on tax grounds." (p.739)

In other words, a lower marginal rate with no bad debt reserve was acceptable as long as they could get out from under the qualifying asset test and use the expanded powers of the Garn-St Germain Act to invest in projects other than residential mortgages.

The present tax provisions are deficient for two reasons: first, other housing lenders, who account for two-thirds of the mortgage market, receive no tax incentives; and second, the structure of the current tax incentive does not encourage incremental increases in mortgage lending. The ABA proposes that the tax incentive for housing finance be restructured to allow all lenders to qualify and encourage incremental mortgage lending.

Specifically, we recommend that a tax credit be developed, at an amount that would be revenue neutral (as compared with the present annual revenue loss of Section 593), and would be available to all lenders on a proportional basis. The current statute actually may encourage an S&L to reduce its qualifying assets down to 60 percent. Under a proportional tax incentive system, an S&L with 60 percent of its assets in mortgages would get twice as much credit as a commercial bank of the same size with 30 percent of its assets in mortgages. As each institution increased its proportion of mortgages, each would get the same additional credit.

Such a revision will be a clear boost to housing in this country and at the same time will make the Code more equitable by providing for functional taxation of all mortgage lenders. This proposal will also allow Congress to eliminate the present Section 593, and put thrifts under Section 585 like commercial banks. There will also be a one time revenue gain from recapture of the prior bad debt reserve for thrifts over \$500 million in assets, as there was when large commercial banks had to recapture their reserves under the Tax Reform Act of 1986.

Functional Taxation-Credit Unions

While this hearing is devoted to the savings and loan industry crisis, we believe it is appropriate to use this opportunity to recommend another major step toward the functional taxation of financial institutions, taxation of credit unions. This was recommended by both the Carter and Reagan Administrations and by the Congressional Budget Office. The tax exemption for these institutions constitutes one of the largest tax expenditures in the financial institution provisions of the Code and it is a slap in the face of fair taxation.

Prior to the 1970s, it might have been reasonable to conclude that credit unions were primarily small, volunteer run, self help institutions which had a limited charter, limited membership and were not really serious competition for taxable financial institutions. Today's credit unions actively compete with other providers of financial services and they are among the most profitable financial institutions in the country. Major changes during the 1970's and 1980's have eroded the uniqueness of credit unions in four key areas: introduction of deposit insurance eliminated the financial link between the depositors and borrowers; erosion of the common bond expanded membership so it can be as broad as anyone over the age of 50; authorization of new products and services allowed credit unions to be fully competitive with banks and savings & loans; and changing demographics led

credit unions to serve higher income customers. We will provide the Committee with a just completed ABA staff white paper which details the four developments. These changes have blurred the distinctions between tax exempt credit unions and taxable financial institutions such that the tax exemption is no longer warranted. Moreover, making credit unions taxable will increase revenues by several hundred million dollars each year.

Chairman ROSTENKOWSKI. Thank you, Mr. Rideout. Ms. Owens.

STATEMENT OF MAUREEN OWENS, CHAIR, TAXATION COMMITTEE (VICE PRESIDENT AND DIRECTOR OF CORPORATE TAXES OF GOLDOME, BUFFALO, NEW YORK), ACCOMPANIED BY MARTIN A. REGALIA, PH.D., VICE PRESIDENT AND CHIEF ECONOMIST

Ms. OWENS. Mr. Chairman, thank you for the opportunity to speak here today. My name is Maureen Owens. I am the vice president and director of Corporate Taxes of Goldome based in Buffalo, New York.

With me is Dr. Martin Regalia, vice president and chief economist of the National Council.

The National Council supports the administration's plan as the foundation for a solution to the problems caused by the large number of insolvent institutions.

We urge the Congress to pass comprehensive legislation as soon as possible, so that we can begin the process of putting this problem behind us.

While the National Council supports these overall regulatory reforms, the funding proposals and the economic assumptions underlying the plan concern us greatly.

We perceive that the way to lower the cost to the taxpayer, and to ensure the success of the program, is to provide incentives for the inflow of private capital.

Eliminating or reducing some of the burdens that will be created by the bill will go a long way toward encouraging the inflow of capital. The council also has a great concern that the economic assumptions, if incorrect, may significantly increase the costs of the program to the taxpayer.

We are also concerned that the funding proposal for the Resolution Trust Corporation makes use of an off-budget Government-sponsored enterprise called the Resolution Funding Corp.

We share the growing concern that this corporation does not meet the requirements of an off-budget agency.

The National Council urges the Congress to consider our written testimony, and to adopt the improvements that we have suggested, in order to make the plan more workable, enhance its likelihood of achieving the desired goals, and reduce the ultimate cost to the taxpayer.

The next area I would like to briefly address are the proposed changes to the tax laws.

The National Council recommends the elimination of the Loan Loss Reserve Recapture. Unless permitted to adapt to current financial conditions through conservative portfolio diversification, the thrift industry will never be consistently profitable, receive a fair return on invested capital, or play a stable role in the providing of home loans.

The single-greatest impediment to adequate diversification is that thrifts must continue to hold 60 percent of their total assets as qualifying assets. If they fail this test they are subject to a tax penalty in the form of a recapture of their existing loan loss reserves.

The National Council recommends that the recapture rules be amended to eliminate the recapture of reserves computed on the percentage-of-taxable income method. Well-managed and profitable thrifts need the ability to adapt to new economic conditions.

In an effort to improve profitability and capital ratio, significant portfolio diversification has already been undertaken by members of the thrift industry.

In answer to charges of past or potential abuse, such as risky investments permitted under State law, does not lie in the continued imposition of an artificial test that hinders profitability, but in rigorous supervisions, such as those imposed on national banks.

We propose an amendment to the code to provide that the loan loss reserves required to be recaptured when a thrift fails the asset test be limited to the portion of the reserves that were not accumulated under the percentage-of-taxable income method.

This would require recapture only on the reserve accumulated in a manner to those accumulated by commercial banks. This amendment to the code should have no revenue impact because no revenue is currently being realized by thrifts from this recapture provision.

Enhancing the profitability of already-profitable institutions by eliminating this asset test would result in increasing their insurance premiums, and ultimately decreasing the cost of resolving the thrift crisis.

Another issue I want to address is the extension of the expiring tax provisions. The provisions basically involve a 50-percent reduction of tax attributes in a reorganization, treatment of mergers as tax-free reorganizations, and the nontaxability of assistance payments.

Extensions of these provisions will provide a valuable tool which will help reduce the ultimate cost of the resolution of insolvent thrifts.

I thank you for the opportunity to speak before you, and I would be happy to answer any questions.

[The statement of Ms. Owens follows:]

Statement of Maureen Owens
of
Goldome
on behalf of the
National Council of Savings Institutions
before the
Committee on Ways and Means
of the
United States Congress
on the
Budget Implications and Current
Tax Rules Relating to
Troubled Savings and Loan Institutions

March 9, 1989

Mr. Chairman, thank you for the opportunity to appear today. My name is Maureen Owens and I am Vice President and Director of Corporate Taxation of Goldome, headquartered in Buffalo, New York. I am here today in my capacity as a member of the Taxation Committee of the National Council of Savings Institutions. Accompanying me is Dr. Martin A. Regalia, Vice President and Chief Economist of the National Council.

The National Council of Savings Institutions is a trade association representing about 500 member institutions nationwide, with about \$560 billion in assets. While about 70 percent of our members are FDIC-insured, FSLIC-insured institutions represent just over 50 percent of member assets. Our member institutions have an average GAAP-capital ratio of 6 percent.

The National Council supports the Administration's plan as the foundation for a solution to the problems caused by the large number of insolvent institutions. We urge the Congress to pass comprehensive legislation as soon as possible so that we can begin the process of putting this problem behind us.

Industry Overview

Before I address the specific questions raised in your letter of invitation, let me take a moment to present a snapshot of the industry. There are really three general classes of institutions today. Based on data as of the end of last September, there were 1,419 institutions with \$379 billion in assets that had capital-to-asset ratios above 5 1/2 percent on the basis of generally accepted accounting principles (GAAP). These institutions earned over \$630 million in the third quarter of last year -- an annual return on assets of 68 basis points.

At the other extreme, 432 institutions with \$138 billion in assets were insolvent and lost over \$2.4 billion in the third quarter of last year -- an annual loss ratio of 704 basis points.

Between these two extremes, there were 1,173 institutions with \$807 billion in assets. These institutions, which are currently solvent but with capital-to-asset ratios below 5 1/2 percent, earned only \$7 million in last year's third quarter -- an annualized return on assets of "0" basis points.

Considering the condition of the industry, the costs imposed on the industry by many of the provisions of this bill, and the current economic environment, however, the National Council believes that the funding proposal and the economic assumptions underlying the bill raise several crucial issues that need to be examined closely. Moreover, as the Committee examines the various elements of this bill, the National Council believes it is essential to keep in mind the need to attract additional private capital into the savings and loan industry if the expenditure of taxpayer funds is to be kept to a minimum.

Regulatory Reform

S. 413 provides for broad-based regulatory reform with the Federal Home Loan Bank Board coming under Treasury oversight, the equalization of capital standards for all insured depository institutions, and a depository insurance mechanism under the responsibility of a single agency. The proposal also calls for more vigorous enforcement and stiffer criminal penalties -- provisions that the National Council strongly supports.

Our own proposal, issued last December, is consistent with the proposal in calling for improved capital standards and rigorous supervision and enforcement. We support the early intervention policies, which are designed to minimize, if not eliminate, the expenditure of public funds. We also endorse the separation of the FSLIC from the Federal Home Loan Bank Board, the future role of the FDIC as administrator of both insurance funds, and the acquisition enhancements included in the proposal -- enhancements that were part of a broader package introduced as S. 2073 in the last Congress and endorsed by the National Council.

Further, the National Council supports the provisions that allow bank holding companies to purchase healthy thrifts. This will assist the flow of capital into the savings industry. The two-year delay contained in the bill should be removed, however, in order to encourage this infusion as quickly as possible.

The National Council also supports the provision in the bill that amends the manner in which credit unions expense their contributions to their insurance fund.

Funding Sources

While the National Council supports these overall regulatory reforms, the funding proposals and the economic assumptions underlying the plan concern us greatly.

There are only three sources of funds identified in the bill: the savings industry, the taxpayer, and the private capital markets. These are, indeed, the only potential sources of new capital.

At the one end, the industry -- through higher deposit insurance premiums and the use of all current retained and perhaps even all future earnings of the Federal Home Loan Bank System -- is being forced to pay what is likely more than it can afford. At the other end, the taxpayer will be required to pick up any costs that remain.

Between these extremes lie the capital markets -- that pool of well-capitalized investors who must be provided with realistic incentives before they will place their capital at risk. These are voluntary contributors who must be

encouraged to invest in and take control of savings institutions. To the extent that provisions of this bill cause viable savings institutions to deteriorate, the cost to the taxpayer will be higher. To the extent that provisions of this bill provide disincentives to the capital markets, the cost to the taxpayer will be higher.

The Need for Private Capital

The way to lower the cost to the taxpayer and ensure the success of the program is to provide incentives for the inflow of private capital.

There are at least five provisions of the bill that discourage private capital and increase the ultimate cost to the taxpayer. They are:

- (1) the five-year moratorium on free movement between the insurance funds;
- (2) the imposition of both exit and entrance fees;
- (3) the heavy burden of deposit insurance premiums;
- (4) the on-going differential in insurance premium assessments; and
- (5) the financial demands placed on the Federal Home Loan Bank System resulting in substantially reduced dividends to member institutions and the potential devaluation of FHLB stock held by these institutions.

Eliminating or reducing these burdens will go a long way toward encouraging the inflow of capital.

With regard to the first two points, the National Council believes that there should be free movement between the insurance funds. At a minimum, however, there should be a common logo or sticker signifying the backing of the Federal Government.

With regard to FDIC's authority to raise premiums, the National Council recommends that the FDIC give Congress not less than six months advance notice whenever it proposes to increase deposit insurance premiums.

The Federal Home Loan Bank System

Under the bill, the Federal Home Loan Bank System is called upon to contribute to repairing the FSLIC insolvency in a number of ways. First, about \$2 billion of existing retained earnings will be used to defease REFCORP bonds. This contribution is over and above approximately \$1 billion already used to defease FICO debt. In making the combined contribution, the FHLB System will lose the future earnings on almost \$3 billion of assets. That is, at today's interest rates, the System's earnings will be reduced by almost \$300 million annually because of the loss of income on these assets. This loss represents almost 20 percent of the System's profits and is roughly equal to the System's annual contribution to reserves.

The National Council has supported this contribution, which has already been earmarked for the FSLIC problem with the passage of the Competitive Equality Banking Act of 1987. We believe that removal of the existing retained earnings represents the prudent limit of Federal Home Loan Bank System contributions.

The bill, however, proposes to take an additional \$300 million per year out of the remaining earnings of the FHLB System. The only way the System can make this additional payment is by reducing dividends sharply.

We are extremely concerned that the net effect of the provisions of S. 413 with respect to the Federal Home Loan Bank System will require a devaluation and subsequent write-down of member institutions' stock in the FHLB System, representing a serious dilution of the industry's capital base. This would ultimately raise the long-term cost of this plan to the taxpayer, and represents a risk that is beyond the ability of the Government to control. The capital markets and the accounting profession will decide ultimately on the value of Federal Home Loan Bank stock, and the early warning signs are not good.

Capital Standards

The National Council has supported and long advocated the equalization of capital standards for all insured depository institutions. Our own proposal for reform, issued last December, is consistent with the Administration's proposal in suggesting a 6 percent GAAP standard. Unfortunately, we find the timetable established in the bill -- June 1, 1991 -- unrealistic, particularly in light of current market conditions.

Quite simply, it is impossible for most of these institutions to meet the capital standards timetable mandated by the bill, especially considering the fact that other provisions of the bill will reduce earnings and discourage the investment of outside capital.

The bill requires recapitalization by solvent S&Ls, but seriously impairs their internal resources for accomplishing this recapitalization. It increases premium payments, reduces the dividends from and erodes the capital value of member institutions' stock holdings in the FHLB System, and significantly accelerates the amortization of goodwill currently included as an asset.

The National Council strongly recommends a five-year capital phase-in, during which time institutions making significant progress toward meeting their capital standards would be subject to close scrutiny, growth limitations, and review of the business plan to ensure their satisfactory progress.

The bill requires investments in certain subsidiaries to be deducted from an institution's capital. The National Council supports the logic underlying this provision, but believes that the comparison standard for determining permissible activities should be based on the federal thrift charter, as opposed to the national bank charter.

Economic Assumptions

The National Council also has great concern that the economic assumptions, if incorrect, may significantly increase the costs of the program to the taxpayer.

The interest rate assumptions call for sharply declining long-term interest rates. If this assumption fails to materialize, the cost of the problem will rise because financing costs will grow.

The assumption about FSLIC-insured institution deposit growth assumes a 7.2 percent annual growth rate. Based on the current level of deposits of about \$1 trillion, that means the proposal assumes deposit growth of about \$70 billion per year. During normal periods, this growth would be considered quite modest -- it barely exceeds the amount of interest credited to deposit accounts. In light of the impact of other provisions in the plan that likely will force the deposit base of the industry to shrink, not grow, this growth assumption is unrealistic.

The funding proposal for the Resolution Trust Corporation (RTC) makes use of an off-budget government-sponsored enterprise called the Resolution Funding Corporation, or REFCORP. We share the growing concern that this corporation does not meet the requirements of an off-budget agency and perhaps should more properly be included as a government entity. The integrity of budget accounting aside, using the government-sponsored entity approach will increase the cost to the taxpayer over the more appropriate direct Treasury funding. Treasury borrows at lower rates than do government sponsored enterprises, and even a modest REFCORP differential of, for example, 25 basis points, would add \$125 million per year to the annual taxpayer cost of the proposal.

The National Council urges the Congress to consider and adopt the improvements that we have suggested in order to make the plan more workable, enhance its likelihood of achieving the desired goals, and reduce the ultimate cost to the taxpayer.

Proposed Changes to the Tax Laws

1. Elimination of Loan Loss Reserve Recapture

Unless permitted to adapt to current financial conditions through conservative portfolio diversification, the thrift industry will never be consistently profitable, receive a fair return on invested capital, or play a stable role in the providing of home loans. The single greatest impediment to adequate diversification is the requirement that thrifts must continue to hold 60 percent of their total assets as "qualifying assets" (generally cash, government obligations, and residential mortgage loans) or face a tax penalty in the form of a recapture of their existing loan loss reserves. The National Council recommends that the recapture rules be amended to eliminate the recapture of reserves computed under the percentage-of-taxable-income method.

Well-managed and profitable thrifts need the ability to adapt to new economic conditions and strengthen themselves, or they could become part of the insolvency problem. As a part of the bill, the thrift industry will be required to help resolve its own crisis through increased insurance contributions, while at the same time its capital requirements will be increased. The bill also requires coordination and standardization of thrift and bank regulation by the FDIC. These proposals raise issues as to whether it is advisable to diminish the distinctions that exist in the law between banks and thrifts. A principal issue would be the effects on the traditional role of thrifts as providers of home mortgage loans.

Despite relatively stable interest rates recently and the use of adjustable rate mortgages, the yield spreads on mortgage loans have narrowed significantly relative to other kinds of bank loans. This is because of accelerating

competition. The use of mortgage-backed securities has opened up mortgage finance to the domestic and international capital markets. Traditional thrifts are often at a competitive disadvantage with other mortgage lenders because of their portfolio restrictions and lack of advanced electronic technology.

In an effort to improve profitability and capital ratios, significant portfolio diversification has been undertaken by the thrift industry. Many of the most profitable thrifts now hold significant amounts of investment securities or real estate assets. Many others offer consumer loans and credit card services. Portfolio holdings of mortgage loans must be distinguished, however, from mortgage origination. Because very many thrifts would choose to restructure their portfolios by selling their mortgage loans in the secondary market does not mean that they would not continue the most profitable activities associated with mortgage lending -- the origination, underwriting, and servicing of the loans. In fact, thrifts are uniquely situated to carry on these activities by virtue of their knowledge of the local real estate market and the relationships they have established with real estate brokers. The answer to charges of past and potential abuse lies not in the continued imposition of an artificial asset test that hinders profitability, but in rigorous supervision, such as that imposed on national banks.

Thrifts that fail the 60 percent test of section 593 of the Code are treated as commercial banks under section 585 for the purpose of determining the inability to use a reserve method. Under this section, banks with assets of over \$500 million must recapture their reserves over a four-year period. Banks with assets of \$500 million or less may continue to use the experience-reserve method. Thrifts, with the approval of the accounting profession, have accounted for their reserves as a permanent difference that would not reverse. This was because the reserves were regarded as a subsidy for having invested in residential mortgage-related assets. Certainly, the legislative history and the method of calculating the additions to the reserve (which bears no relationship to risk determination) indicate that the percentage-of-taxable-income method was intended as a subsidy and not as a deferred tax liability. (Commercial banks accounted for their reserves as deferrals of tax liabilities.)

Although the Code permits taxes resulting from the recapture of the reserve to be spread over four years, for financial reporting purposes, Accounting Principles Board Opinion No. 23 requires that thrifts report the tax consequences of their reserve recapture in the calendar quarter in which they no longer satisfy the tests of section 593. This lump-sum recapture has a devastating impact on the thrifts' financial statements that exaggerate the impact of the tax law and reduce capital ratios. Apart from the possible effect on solvency, a thrift's ability to raise investor capital may be impaired seriously.

We propose an amendment to section 593 of the Code to provide that the loan loss reserves required to be recaptured when a thrift fails the 60 percent test be limited to the portion of the reserves that were not accumulated under the percentage-of-taxable-income method. This would require recapture only on the reserve accumulated in a manner similar to those accumulated by commercial banks. This amendment of the Code will have no revenue effect because no revenue is being realized currently from thrifts by the recapture provision. Profitable thrifts, the very institutions that should be encouraged to enhance their profitability through diversification, have avoided the impact of the recapture provision simply by not allowing their holdings of qualifying assets to drop below 60 percent.

The effect of the recapture provision is to prevent the institutions that can most benefit from adapting to the changed financial environment from doing so. These are the institutions whose very profitability demonstrates that their officers and directors have the managerial skills and prudence to flourish if permitted to adapt to current market conditions. Enhancing the profitability of already profitable institutions would result in increasing their insurance premiums and, ultimately, decreasing the cost of resolving the FSLIC crisis.

Arguments that the percentage-of-taxable-income reserves represent a deferral of tax that eventually must be paid should not be permitted to stand in the face of the larger policy considerations presented by the FSLIC crisis. In any case, these arguments are insupportable based on the reality and history of this method. In order to serve a non-tax purpose -- encouraging specialization in residential mortgage lending and certain other specified types of lending -- thrifts were permitted deductions for additions to reserves in excess of those needed for a proper measurement of income. A second concept that supported the use of the percentage-of-taxable-income method in prior years is that federal regulations require that thrifts maintain a certain percentage of their assets in zero- or low-yielding reserves to satisfy liquidity requirements. Excess bad debt reserves, especially those measured as a percentage of taxable income, enable financial institutions to build up some of their reserves or liquidity requirements out of pre-tax income, partially compensating them for the burden of the regulations.

In past years, there have been recommendations to replace the percentage-of-taxable-income method with some sort of generalized tax incentive for mortgage lending. When Congress created the percentage-of-taxable-income method, it did so as a matter of tax expenditure policy. Congress wished to achieve what was, in the past, a justifiable objective -- encouragement of residential mortgage lending. It was unfortunate that Congress settled on the use of a reserve method to achieve this objective, because this choice prevents the achievement of a current public policy objective -- investment diversification by profitable thrifts. For the same reasons of tax expenditure policy, and because there will be no revenue impact, the National Council believes there should be no recapture of the reserves computed under the percentage-of-taxable-income method when a thrift no longer chooses to meet the 60 percent qualifying assets test.

2. Expiring Provisions

The Economic Recovery Tax Act of 1981 (1981 Act) added several provisions to the Internal Revenue Code that benefit the acquirers of troubled thrifts. These provisions were significantly modified by the Technical Corrections and Miscellaneous Revenue Act of 1988, and, in general, these provisions expire after 1989. The first of these provisions provides that FSLIC/FDIC assistance payments are excluded from taxable income and do not reduce the bases of the reorganized thrifts' assets. Payments made in connection with a tax-free reorganization, and to a limited extent, a taxable acquisition, may, however, result in a 50 percent reduction in the tax attributes of the acquired thrift. A second provision provides that the judicially created continuity-of-shareholder-interest requirement will not apply, provided certain conditions are satisfied. After the expiration of this provision, it is unlikely that an acquisition of an insolvent thrift could qualify as a tax-free reorganization. A third provision reduces the percentage ownership of a financially troubled thrift that must be retained after a tax-free reorganization from 50 percent to 20 percent if the NOL carryovers and built-in losses (in excess of the 25 percent threshold) are not to be reduced.

As a preliminary matter, the elimination of the continuity-of-shareholder-interest requirement to permit a tax-free acquisition of a mutual thrift by a stock thrift and vice versa is simply an elimination of a tax inequity. It is an adaptation of the tax laws to cover a legitimate business transaction by an entity, a mutual savings bank, whose historical distinctiveness, for the most part, has been eroded.

With respect to expiring 1981 Act provisions in general, the National Council believes that they should be extended. They provide Federal regulators much needed flexibility to deal with troubled thrifts and banks. In this respect, it should be made clear that the provisions apply to assistance provided through the Resolution Trust Corporation. If the provisions are not extended, the increased cost of thrift case resolutions under the bill will be directly reflected in increased Treasury expenditures. The expiring provisions create two kinds of cost savings. First, the cost of FDIC and FSLIC assistance transactions is reduced, thereby having a positive effect on the deficit. Second, the provisions make it more likely that transactions will occur in which all or most of a troubled thrift's assets are acquired, including the nonperforming or troubled assets. Such transactions are preferable to acquisition transactions following an FSLIC or FDIC liquidation where the acquirer takes only the good assets. Where all of a troubled thrift's assets are acquired, the agency's costs are less as a result of higher asset realization through management of the nonperforming assets by the acquirer. In addition, minimizing the number of liquidations will avoid exacerbating the depressed real estate markets that, in large part, created the thrift crisis in the Southwest.

In hindsight, some of the early acquisitions of troubled thrifts engineered by the Federal Home Loan Bank Board may be criticized for conferring overly generous tax benefits. However, inefficiencies are typical of any "shake-down" period. They were particularly unavoidable given the desperate straits of the FSLIC recently. Sufficient sophistication through the processes of analysis and education now exists within the FHLB Board and the FDIC to assure that maximum benefit will accrue to them in future tax-benefited thrift and bank acquisitions. The increased sophistication of the FHLB Board negotiators is evidenced in some of its recent transactions. Contracts entered into in these transactions call for all or some of the tax benefits to be rebated to the FSLIC. To the extent that FSLIC did not capture all of the tax benefit directly by contract, many of them were recaptured indirectly through more favorable terms in other parts of the contract. In the future, FSLIC and FDIC case resolutions should recognize the costs to taxpayers as well as the costs to the insurance fund. The two objectives may conflict, and each consideration should be discussed explicitly in the write-up of the case resolution justification. In summary, whatever waste may be imputed to the resolution process through the use of tax incentives to date, it will be no less wasteful to permit the expiration of the 1981 Act provisions when greater sophistication has been acquired such that their continued use will make a less costly end to the current crisis possible.

Thank you. I would be happy to answer any of your questions.

Chairman ROSTENKOWSKI. Thank you, Ms. Owens. Mr. Engelke.

STATEMENT OF GEORGE L. ENGELKE, JR., MEMBER, EXECUTIVE COMMITTEE AND BOARD OF DIRECTORS, UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS (CHIEF EXECUTIVE OFFICER, ASTORIA FEDERAL SAVINGS AND LOAN ASSOCIATION, JACKSON HEIGHTS, NEW YORK)

Mr. ENGELKE. Good morning. My name is George Engelke, Jr. I am chief executive officer of Astoria Federal Savings and Loan Association of Jackson Heights, New York, and appear today in my capacity as a director of the U.S. League of Savings Institutions.

The league and its 3,000-member savings institutions nationwide appreciate this opportunity to discuss the tax rules regarding troubled federally-insured depositories, and the legislation put forth by the Bush administration to address the crisis at the Federal Savings and Loan Insurance Corporation.

The U.S. League appreciates the conference action on last fall's Technical and Miscellaneous Revenue Act, extending to December 31, 1989, with modifications, certain tax rules applying to financially troubled thrifts.

We believe that the continued availability of these tax provisions to the FSLIC is appropriate. Last year the insolvent thrift insurance fund had scarce cash resources to commit to acquirers of troubled institutions, and these tax provisions became essentially the only tools available for case resolution.

In their absence the agency would have had to resort to more expensive mergers, and in some cases liquidations, which would have boosted overall Federal deficit numbers since the entire depositor payoff would have been scored as a Federal outlay.

Chairman Wall testified before you last month that the FSLIC's utilization of the tax tools will ultimately save the taxpayer money. We cannot of course evaluate the efficiency of these deals.

The agreements entered into by FSLIC are not publicly available and we, like your committee, must await the analysis underway by the General Accounting Office.

However, we concur with the view that tax revenues lost through the use of these provisions be included in FSLIC resolution cost estimates and comparisons.

As you examine the question of a further extension beyond year end 1989, we understand fully the committee's reluctance to proceed before Congress deals with the Comprehensive Financial Institutions Reform Recovery and Enforcement Act proposed by the Bush administration.

But as a fail-safe option, the thrift business supports the recommendation of FDIC Chairman Seidman, that extending these tax provisions would preserve additional flexibility in dealing with its growing resolution caseload.

Whatever the outcome of the extension decision, there is one particular omission in the administration plan, as currently introduced, which needs correction.

That legislation contemplates removal of the insolvent FSLIC thrift caseload to a Resolution Trust Corporation on enactment, in effect as a successor-in-interest to the present FSLIC.

Language to enable the RTC to utilize the special Tax Code provisions now available to the FSLIC must be inserted; otherwise, the FDIC would still be permitted to avail itself of tax incentives for supervisory acquisitions of problem banks while the new RTC would not.

Prospective purchasers of troubled depositories would thus be encouraged to bid on problem banks, and discouraged from relieving the Government of its problem FSLIC thrifts.

Congress obviously should avoid this strange result. We were heartened when President Bush announced on February 6 that he was sending a legislative proposal to Capitol Hill. Implicit in the President's announcement was the recognition that the financial burdens for resolving the accumulated problems of FSLIC was far beyond the resources of the healthy and solvent part of the thrift industry.

When a legislative draft on February 22 appeared, it became apparent that a viable thrift industry cannot be sustained.

First, the bill introduced in the Senate calls upon the industry to achieve capital levels at least comparable to bank requirements by June 1, 1991. Shearson Lehman, in a report, estimates that our industry would need to raise \$20 to \$35 billion in capital to comply, a totally unachievable task in 27 months for an industry which raised just \$20 billion in the last 9 years.

While we readily subscribe to building capital, this time frame is unrealistic, and it ignores transitions needed to accommodate institutions which booked good will from supervisory rescues, and sold loans with losses deferred, under encouragement from regulatory officials.

Second, the administration's plan sets forth a detailed schedule of increased deposit insurance premium costs. These higher premiums, which could exceed four times the traditional premium level, run directly counter to the goal of building and attracting additional capital.

The costs for healthy institutions of FSLIC are aggravated further by hidden burdens which arise from tapping the retained earnings and dividend-paying capacity of the Federal Home Loan Bank System which is wholly owned by the thrift industry.

Third, the President's merger of the FSLIC into the FDIC installs the FDIC administratively as supervisor and examiner of the remaining thrift industry yet while surviving thrifts would meet comparable or more stringent capital requirements, and pay higher insurance of account premiums for equivalent depositor protection. The FDIC seal is denied to thrifts.

This continued, unnecessary differentiation of insurance seals, in our opinion invites further problems with the public's confidence.

Finally, we disagree with a Bush plan intent to relegate the Federal Home Loan Bank Board to bureau status in the Department of the Treasury.

We appreciate that Treasury oversight is appropriate where taxpayer funds are being utilized. Thus we support the installation of a Treasury Secretary on the board handling the Resolution Trust Corporation and off-budget bonding mechanisms.

This would provide appropriate stewardship of future Federal outlays and tax expenditures. Any Treasury involvement or control

of the Federal Home Loan Bank System which provides needed funds for housing would be inappropriate.

Thank you very much for allowing me to appear before you.
[The statement of Mr. Engelke follows:]

STATEMENT OF GEORGE L. ENGELKE, JR.
On Behalf of the United States League of Savings Institutions
To the Committee on Ways and Means
House of Representatives
March 9, 1989

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is George L. Engelke, Jr. I am Chief Executive Officer of Astoria Federal Savings & Loan Association of Jackson Heights, New York, and appear today in my capacity as a director of the U.S. League of Savings Institutions.

The League and its 3,000 member savings institutions nationwide appreciate this opportunity to discuss the tax rules regarding troubled federally insured depositories, the legislation put forth in the Senate by the Bush Administration to address the crisis at the Federal Savings and Loan Insurance Corporation, and several other legislative issues within the jurisdiction of this distinguished committee.

Savings Institutions' Role in Housing Finance

We applaud President Bush and the Congress for moving so quickly to resolve the FSLIC crisis. To quote Treasury Secretary Brady from his statement to the Senate Banking Committee on February 22nd:

"Today, as in the past, the S&L industry plays an important role in housing finance. The S&L industry's problems do not stem fundamentally from their traditional business of mortgage financing."

We agree that our industry continues to perform an important public service in our nation's financial system. He is also correct in observing that those thrifts that have stayed with housing finance have not caused the current problems. The huge losses now being acknowledged can be traced, in large measure, to institutions which deserted mortgage finance. Secretary Brady continued in his Senate testimony:

"We believe the best thing for housing finance in this country is a strong and sound S&L industry."

These are reassuring words, coming as they do at a time when our basic role as an instrument of national housing policy is being questioned. The revolution in mortgage finance of the 1980s has created numerous misunderstandings concerning the significance of thrifts in meeting mortgage credit needs. To set the record straight, I want to make a few brief points.

There are three main measures of the role played by our specialized industry: 1) our share of residential loans made or originated; 2) our share of residential loans "held" or outstanding as ultimate housing credit providers; and 3) the percentage of our investment portfolios dedicated to residential assets.

On all three counts, we continue to focus on housing finance for the American people.

Savings and loans and savings banks accounted for nearly one-half of mortgage loan originations last year. This was more than twice the market share of our closest competitor group, the commercial banks. While our direct market share was high, it grows well beyond 50% when savings institution mortgage banking subsidiaries are included.

Homeownership is only achievable for most families if long-term credit is possible through repayment schedules in affordable, monthly amounts. Thus the ultimate long-term credit source is extremely important in the housing delivery process. Here again savings institutions predominate: holding 49% of all outstanding whole home mortgage loans and 32% of outstanding securities backed by home loans -- or in combination, 43% of the total. Commercial banks, again the next largest category, hold a combined 19% of whole mortgage loans and mortgage-backed securities. The specialized savings institutions' share of holdings exists despite the fact that commercial banks have 2 1/2 times our assets and service locations. Should our institutions somehow disappear, the question must be asked: Who can be depended upon to pick up our current holdings? Clearly, savings institutions are essential to homeownership opportunities.

Further, contrary to occasional editorial comments, the asset composition of thrifts continues today to differ greatly from that of commercial banks, as it has done historically. When portfolio composition is compared as of September 30, 1988, you will find that more than 63% of assets are in household (mortgage and consumer) items at thrift institutions, while household financial assets constitute 24% of commercial bank portfolios.

In sum, there is simply no basis for the oft-repeated assertion that thrifts have become "just like" commercial banks, and that there is, therefore, no justification for sustaining a separate thrift system.

Provisions for Financially Troubled Institutions

The U.S. League appreciates the conference action on last fall's Technical and Miscellaneous Revenue Act of 1988 extending to December 31, 1989, with modifications, certain tax rules applying to financially troubled thrifts. In brief, these rules: permit recipients of FSLIC assistance to exclude such payments from gross income (Sec. 597); permit certain acquisitions of troubled thrifts to qualify as tax-free reorganizations without regard to continuity of interest requirements (Sec. 368(a)(3)(D)); and enable the carryforward of net operating losses (NOL) to acquirers of troubled thrifts (Sec. 382(l)(5)(F)). The provisions were altered last year by reducing the NOL carryforward, built-in losses (on portfolio and marketable securities) and interest expense by 50 percent of any tax-free FSLIC assistance payments received, effective from January 1989. In addition, parallel provisions were extended for the first time to the Federal Deposit Insurance Corporation's case resolution activities.

As the U.S. League testified before the Senate Finance Taxation and Debt Management Subcommittee last March, we continue to believe that the continued availability of these tax provisions to the FSLIC was, and is, appropriate. In the circumstances of 1988, political and economic, this was sound public policy for FSLIC. The insolvent thrift insurance fund had scarce cash resources to commit to acquirers of troubled institutions, and these tax provisions became essentially the

only tools available for case resolutions. In their absence, the agency would have had to resort to more expensive mergers and, in some cases, liquidations -- which would have massively boosted overall federal deficit numbers since the entire depositor payoff would be scored as a federal outlay. Any revenue losses associated with the extension of the expiring tax provisions should have been offset by outlay savings.

Chairman Wall testified before you last month that the FSLIC's utilization of the tax tools will ultimately save the taxpayer money. We cannot, of course, evaluate the efficiency of these deals -- particularly those accomplished as the end of the year approached. The detailed agreements entered into by FSLIC are not publicly available and we, like your Committee, must await the analysis underway by the General Accounting Office. We absolutely concur with the view that the tax revenues lost through the use of these provisions be included in FSLIC resolution cost estimates and comparisons.

As you examine the question of a further extension beyond year-end 1989, we understand fully the Committee's reluctance to proceed before the Congress deals with the comprehensive "Financial Institutions Reform, Recovery and Enforcement Act" (FIRREA) proposed by the Bush Administration. If the various funding devices and resources provided by that complex legislative initiative are sufficient to isolate and promptly dispose of the insolvent caseload of the FSLIC, a further extension may not be necessary. But, as a fail-safe option, we support the recommendation of FDIC Chairman Seidman that extending these tax provisions would preserve additional flexibility in dealing with their daunting assignments.

Whatever the outcome of the extension decision, there is one particular omission in FIRREA as currently introduced (as S.413) in the other body. That legislation contemplates removal of the insolvent FSLIC thrift caseload to a Resolution Trust Corporation (RTC) on enactment -- in effect, as a successor in interest to the present FSLIC. For the balance of the year 1989, no provision is made to permit the RTC to utilize the special tax code provisions of sections 368, 382 and 597, even though those would be available to FSLIC if it were not being merged administratively with the FDIC.

Without some language to enable the RTC to utilize the special code provisions now available to the FSLIC, an anomaly would result: the FDIC would still be permitted to avail itself of tax incentives for supervisory acquisitions of problem banks while the new RTC would not -- at least for the remainder of this calendar year. Prospective purchasers of troubled depositories would thus be encouraged to bid on problem banks and discouraged from relieving the government of its problem FSLIC thrifts. Congress, obviously, should avoid this strange result.

Savings Industry Evaluation of FIRREA, as Introduced

Since the enactment of remedial legislation addressing the FSLIC crisis has become one of the major projects of this 101st Congress, permit me to share with you a brief summary of the U.S. League's reaction to FIRREA. (A detailed response appears in testimony delivered earlier this week to the Senate Banking Committee and an appearance is scheduled next Thursday before the Financial Institutions' Subcommittee of House Banking.)

We were heartened when President Bush announced on February 6 that he was sending a legislative proposal to Capitol Hill. The general outline contained several positive aspects: 1) acknowledgement of the federal government's obligation and reassurance to customers that their deposits are backed by the full faith and credit of the United States (to the \$100,000 limit on account coverage); 2) separation of the FSLIC from the Federal Home Loan Bank Board and its other responsibilities; 3) recognition that savings institutions are still important to housing America; 4) isolation of the task of liquidating or merging insolvent institutions in the RTC (mentioned above); 5) independence for healthy institutions from the debilitating burdens of an insolvent FSLIC; and 6) sufficient resources to the Justice Department and the agencies to identify and prosecute those who have abused the thrift charter.

Implicit in the President's announcement was the recognition that the financial burdens for resolving the accumulated problems of FSLIC was far beyond the resources of the healthy and solvent five-sixths of the thrift industry.

However, with release of a follow-up description on February 14 and the legislative draft on February 22, it became apparent that a viable housing specialized depository industry cannot be sustained under the Administration's proposal.

First, the bill introduced in the Senate calls upon the industry to achieve capital levels comparable to FDIC requirements by June 1, 1991. Shearson Lehman estimates that our industry would need to raise \$20-\$35 billion in capital to comply -- a totally unachievable task in 27 months for an industry which raised just \$20 billion in the years 1980-88 (of which approximately \$13 billion was in the form of mutual to stock conversion capital, a one-time event). While we readily subscribe to building capital, this timeframe is unrealistic -- and it ignores transitions needed to accommodate institutions which booked goodwill from supervisory rescues and sold loans with deferred losses under encouragement from regulatory officials.

Next, the Administration's plan sets forth a detailed schedule of increased deposit insurance premium costs -- establishing, in the process, a permanent disparity with competitors which now possess FDIC or NCUSIF deposit insurance coverage. The higher premiums, which could exceed four times the traditional premium level, run directly counter to the goal of building and attracting additional capital -- and are particularly damaging to those marginal institutions most in need of higher capital. The "double whammy" of raising premium costs while mandating higher capital portends future insolvencies. The disparity in operational costs for healthy institutions of FSLIC ancestry is aggravated further by hidden burdens which arise from tapping the retained earnings and dividend-paying capacity of the FHLBank System wholly owned by the thrift industry as part of the complex off-budget funding scheme.

The day following the President's announcement, the die was cast for an administrative merger of the FSLIC into the FDIC by execution of a Managing Agreement between the agencies for the handling of FSLIC's current caseload of insolvent thrifts. The legislation installs the FDIC administratively as supervisor and examiner of the remaining thrift industry (though it goes to elaborate lengths to avoid commingling financial resources). Yet, while surviving thrifts would meet comparable or more stringent capital requirements, and pay higher insurance-of-accounts premiums for equivalent depositor

protection, the unqualified FDIC seal or emblem is denied to thrifts coming under FDIC authority. The continued unnecessary differentiation of insurance seals invites further problems with the public's confidence in federally insured depository institutions.

Finally, we disagree with the portion of the legislation which reorganizes the agency structure by assigning the Federal Home Loan Bank Board -- as charterer of federal thrifts, coordinator of the FHLBank System, and administrator of the savings and loan holding company laws -- to "bureau" status in the Department of the Treasury. We appreciate that Treasury oversight is appropriate where taxpayer funds are being utilized. Thus, we support the installation of the Treasury Secretary on the board handling the RTC and off-budget bonding mechanisms under the complex legislation. But further involvement in the independent housing finance system is as inappropriate as it would be in the Farm Credit System. We believe that the presence of the Treasury on the RTC oversight board and the requirement for closer consultation with the Treasury on all other case resolutions by the federal deposit insurer will provide the appropriate stewardship of future federal dollar outlays and tax expenditures, if the special tax provisions are extended past year-end.

Related Concerns

As thrift institutions confront an uncertain future in the financial services marketplace -- with fundamental change likely in regulatory structure and operating environments -- it would be appropriate for the Congress to clarify a lingering uncertainty affecting our institutions. Under existing tax law (Sec. 593), a thrift institution must maintain 60% of its assets in "qualifying real estate loans" as described in Sec. 7701(a)(19) to use the percentage-of-taxable-income bad debt reserve deduction. It is not clear what the consequences are if a domestic building and loan association or saving bank should fail to meet this test for whatever reason, however temporary in duration. Conceivably, an institution of \$500 million or more in assets could find itself subject to the charge-off applied to larger commercial banks under the 1986 Tax Act -- which would have particularly adverse financial accounting impact. We would recommend that language be added to permit a thrift institution to rehabilitate itself to qualifying status, and would be happy to work with staff to accomplish such a clarification of existing law.

Extension of Exception from "At Risk" Limitations

The 1986 Tax Reform Act extended the "at risk" loss limitation rules to deductions incurred with respect to the purchase of real property through nonrecourse financing. That law contained an exception for financings by "qualified persons" including institutions, such as savings associations, regularly engaged in the business of lending. However, an institutional lender will lose its qualified person status if it is also owner of the realty for which the financing is offered -- subjecting the buyer/borrower again to the "at risk" exposure.

In extending the "at risk" coverage to real estate, the authors of the '86 law were concerned with abuses arising from overvalued properties and inflated deductions; however, a separate exception from application of the "at risk" limitations was created for transactions involving "related

persons" where the financing was deemed "commercially reasonable" and on substantially the same terms as other loans made by the lending institution.

A significant problem still exists where savings institutions attempt to finance sales of foreclosed real estate to unrelated third parties. Here the "at risk" limits are triggered and the depreciable amount for potential buyers/borrowers is limited to the downpayment rather than the purchase price. The "related parties" exception should be extended to such situations. The "commercially reasonable" requirement and the imputed interest rules will guard against any potential abuses.

Encouraging Private-Sector Savings

The U.S. League would also like to voice a concern about the new college tuition savings incentive included in the 1988 Technical and Miscellaneous Revenue Act. Section 135 of that law will exclude from gross income, beginning next January 1, the interest earned on Series EE Savings Bonds when the proceeds on redemption are used to pay qualified higher education expenses. The federal government is already a major competitor for individual and household savings at a time when the discretionary savings rate of households, our major source of funds, is at on all-time low. Allowing the Treasury to offer a college savings plan which totally excludes tax on interest buildup will generate a new round of financial institution disintermediation at the same time we're trying to increase private-sector savings.

We strongly support the concept of tax incentives for savings toward college education expenses, but feel strongly that such opportunities should be extended to all private-sector insured depositories, including thrift institutions.

As home-lending specialists we are also concerned about the affordability barrier to families entering into first-time homeownership. One approach we support would permit first time buyers to apply, without tax penalty, a designated amount of funds built up in an Individual Retirement Account or 401(k) plan toward a downpayment for first-time home purchase. This incorporates part of Rep. Richard Schulze's American Dream Savings Incentives Act and, in our opinion, any revenue impact would be inconsequential since few individuals voluntarily incur such a withdrawal penalty. It is also our belief that the concept does not conflict with the national goal of encouraging savings toward retirement since homeownership constitutes a major source of retirement security for millions of Americans.

As a final matter, a clarification is needed in the "prohibited transaction" section 4975(c)(1)(E) of the Internal Revenue Code. Where an institution acts as a trustee for a self-directed IRA account, the present language appears to prevent the trustee institution from investing IRA assets or income in its own common stock. The rationale for prohibiting such transactions disappears, in our view, where a self-directed IRA is involved and inhibits the use of IRA savings in the manner desired by the beneficiary.

I have appreciated this opportunity to address aspects of savings institution tax law within the jurisdiction of your distinguished Committee and look forward to your questions.

Chairman ROSTENKOWSKI. Thank you, Mr. Engelke. Mr. Gibbons.

Mr. GIBBONS. The testimony of the panel disappoints me. I have expressed my opinion to Mr. Rideout before, and I expressed it to you, Mr. Engelke.

I think this is a mess that has been made in our generation. I do not support, will not vote for anything to push it off into future generations, and that is all that we are doing with this.

I realize, Mr. Engelke, that you are going to have a terrible time trying to raise capital, but somebody has to pay for all this mess, and we are going to have to finally pass it on to the taxpayers.

All of you are in the banking business and you know how money compounds, particularly at the interest rates that we are now having to borrow at, and so I am really disappointed that both of you have not sort of bitten the bullet a lot more, and come forward with some suggestion as to how to pay for this, other than passing it off to my children and grandchildren, or great-grandchildren.

So, I am at a loss to really ask you an intelligent question. We are so far apart in the way to solve this problem. I realize, Mr. Engelke, you cannot get money out of a turnip or out of a stone, or any place else, and that your institutions are in terrible shape.

To the extent that I am responsible for it, I apologize to everyone, but I just do not see why we cannot face up to this thing, levy the necessary service charge, a tax or whatever it is, get this thing behind us, not go out and borrow more money, new money, to bail out a condition that was already caused by too much borrowing.

I realize the necessity for getting this thing out of the way in a hurry because it is costing money every day and is creating instability in our whole depository system. But, frankly, your testimony just leaves me flat.

I do not think I have a question. I just want to make that statement.

Mr. ENGELKE. May I respond?

Mr. GIBBONS. Yes, sir.

Mr. ENGELKE. Really, the delay in capital is not to preserve those that we would support a death penalty for. We have no sympathy, or empathy, or anything like that for what has happened in this industry. We are on your side. I do not want my children and grandchildren to pay for this thing either, and I do not want my institution to pay for it, which happens to be extremely well capitalized.

Mr. GIBBONS. I appreciate that, but we are going to have to raise some money somewhere. The question is, where do we raise it? We obviously cannot get it out of you; it is just not there. It would collapse all the good institutions along with it. So we have got to spread the burden.

Now the question is, do we spread it to someone who is yet unborn, or do we pay for it—we are not talking about a heck of a lot of money when you are talking in Washington terms here.

And I think that we could raise the money if we just bit the bullet and decided we were going to do it, and we would save all that huge borrowing cost way out into the future. That is my theory.

Mr. RIDEOUT. Mr. Chairman, may I respond to at least one of the points which was raised by the U.S. League having to do with the

capital standards that are contemplated in the bill, which would say that by June 1, 1991, the savings and loans would have to achieve capital standards that would be equivalent to those of banks.

There is a good deal I think of misinformation about what would happen to those institutions that failed to achieve that standard, and the implication of that misinformation seems to be that those institutions would be put out of business.

The bill does not say that. In effect what the bill says is that those institutions would not be allowed to grow. The practical effect of the bill is that those institutions would be treated in the same way that banks who are currently capital-deficient are treated.

They would enter into a supervisory agreement with their regulator in which a number of steps would be spelled out to determine how they would get to their stated capital objective.

Dividend restrictions, control of expenses, growth of assets; items of that kind would be put in place to ensure that these institutions could meet sufficient capital standards in good time.

For those who could not, obviously, they would need to be put up for merger, and for sale, in one way or another.

But I want to assure you that our reading of the bill would indicate that failure to meet that June 1, 1991, deadline would not put institutions automatically out of business. I think it is a very important point.

We have to have good sound capital in the thrift industry and standards on accounting and supervision as we do in the banking industry.

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. GIBBONS. Mr. Engelke wants to make a statement.

Chairman ROSTENKOWSKI. I am sorry.

Mr. ENGELKE. We are not opposed to stopping growth. That is another major concern that we have had all along, and we wanted the Bank Board to stop a long time ago. We agree with controlling growth if there is no capital. Capital must be a determinant of growth.

The only problem we see here, we just want Congress to consider, is the fact that there are institutions that are in reasonable shape right now, that have to meet a much higher standard very, very quickly.

That is not to say we disagree with the standard. We agree with the standard. We are looking for a good analysis of these institutions to make sure that we are not throwing out someone that is clearly in good shape and will move forward and just needs the time for it. It is not to use the word "forbearance." It is out of our vocabulary.

Chairman ROSTENKOWSKI. Well, Mr. Engelke, do you have any thoughts regarding the issue of whether the assistance program should be financed in an off-budget manner, or an on-budget manner?

Mr. ENGELKE. I certainly do and I appreciate your question, Mr. Chairman. Very interestingly, Goldman Sachs, I believe it was, predicted a 30 basis point differential in the financing, off versus on

budget, times \$50 billion. That happens to come out to \$150 million.

Yours truly believes the spread will be larger. If it happens to be 60 basis points, the number is \$300 million, which happens to be a number that the proposal is looking for from the Federal Home Loan Bank System in perpetuity, each and every year from here on out, and, therefore, I would certainly say if we wanted to save some money, and save our grandchildren and children, that if there is some way, politically, to do it, on budget is certainly an answer. It saves \$150 to \$300 million a year for 30 years. I think that is important.

Chairman ROSTENKOWSKI. Anybody else?

Mr. RIDEOUT. I would just make the observation, Mr. Chairman, that we do not have a strong feeling about it, one way or another. In my statement I think I indicated that if the Congress can put it on budget and do it quickly, so we can get on with solving the problem, that that would be perfectly acceptable with us.

I think it is a complex thing to look at from a total financing cost point of view. Clearly doing it off budget will be more expensive and there are various estimates to how much more expensive.

There also is the theory, and I think it is one that is worth examining, and I do not have the answers to it, that if this matter is put on budget, or if there is some exemption from the Gramm-Rudman-Hollings test, that investors might raise the overall cost of Government financing to an extent that it might be more expensive to do it on budget than it would be to do off budget.

I do not know if that is a realistic possibility or not. I think it is a very complex question and one that the committee is going to have to wrestle with.

Chairman ROSTENKOWSKI. Mr. McGrath will inquire.

Mr. McGRATH. Thank you, Mr. Chairman.

I am concerned. I have a bank that serves Long Island, and going back into, I guess 1982, or 1981, when we faced this problem in New York State—I would hasten to point out that New York State banks seemingly are not the problem here.

There were created a number of phoenixes to take over banks that were in somewhat bad shape at that time, and at that time, the Federal Home Loan Bank made some arrangements with some of these phoenix institutions which were a handshake and a deal.

The legislation that we find before us today would abrogate some of the conditions of the deals that were made at that time. The result is that banks that did the job and took over failing banks, could, with the enactment of some of this legislation, be put in the same position that we find some of the banks in Texas and California today.

I would only hope that perhaps some transition on some of these provisions in the bill could be enacted so that deals that were made 6 and 7 years ago to the benefit of the banking system in our country could be preserved. I would not want to exacerbate the problem by provisions in the new bill.

Now, Maureen, having said that, with respect to testimony on proposed tax law changes, it seems to me that when we were sitting around this room in 1984 through 1986, there was a revenue price on just about everything that we did, and to eliminate the

loan loss reserve recapture seems to me to be something that we had a price on at the time.

Your testimony says it is just the opposite. I wonder if you could explain that to us.

Ms. OWENS. Sure. The distinction that I am making is the reserve recapture portion is simply attributed to the past percentage of taxable income deductions.

The reserve recapture estimates that you are probably discussing were the recapture of the reserves that a normal commercial bank would take. Those are probably the amounts that were included. The other portion may have been included—I do not know what the revenue estimate is—but it currently is not a source of revenue because there are institutions such as my own, Goldome, that are continuing to pass the qualifying asset test and avoiding the recapture.

That, however, does limit our diversification abilities.

Mr. McGRATH. Would our other panelists agree with that assessment?

Mr. RIDEOUT. Congressman, I would just add that in the Tax Reform Act of 1986, as I understand it, all banks over \$500 million in assets were required to recapture, over a period of time, their tax reserves, and we think the savings and loan should do exactly what the banks have had to do. We think it is a tax equity issue.

Mr. McGRATH. At the same level of assets?

Mr. RIDEOUT. Certainly, \$500 million would be a reasonable level.

Mr. McGRATH. George, what do you have to say?

Mr. ENGELKE. Well, I cannot quite agree with that, I guess. I believe the answer is in the maintenance of a qualified thrift lender test. Our testimony before the House Banking Subcommittee a few weeks ago indicated that we are in support of a thrift industry. This problem, in this industry, was clearly exacerbated by those institutions who recklessly went away from home lending.

The U.S. League, by and large, is supported, and is a group of people that are believers in home lending. That is what we are good at, that is what we do best, and I think there is statistical information from that league that we would be happy to furnish, that shows that the problem institutions had lesser percentages in housing than those of us that are successful in this business.

And therefore, I believe—in fact we just reviewed this yesterday—the U.S. League will probably support an even higher-qualified thrift lending test as long as some additional consumer lending and specifically, liquidity, which we believe is very important in this business, is included in the increased qualified thrift lender test.

Mr. McGRATH. I have heard members of this panel of credit union representatives articulated a plan that we put into effect during DEFRA in 1984 where under 1 percent of the assets went to this particular insurance fund. We have had testimony already today that that would accrue, if it were applied to thrifts and commercial banks, a \$27 billion reduction to the deficit.

Would the commercial banks or thrifts want to bite off the same kind of a provision in order to insure themselves?

Mr. RIDEOUT. Congressman, I would be happy to answer that for the bankers. We think that the credit unions should account for

their insurance premiums and their insurance payments on the same basis that the banks do, which is to expense them on an ongoing basis.

Mr. McGRATH. May I just interject? Aren't they subject to the same GAAP accounting regulations that you are?

Mr. RIDEOUT. Not insofar as this question of the special 1 percent of deposits premium that was paid back in 1984, and the ongoing 1 percent of incremental deposit growth premium is concerned. Apparently that particular cash payment which was made, I guess checks or cash were given to the Credit Union Insurance Fund, continue to be carried as assets on the books of the credit union.

We think, in effect, that is a bad case of double accounting. We think if the credit union is going to reflect in fact, a healthy balance sheet and not overstate its assets, that you shouldn't allow the credit unions to double count that proportion that is attributed to the 1 percent of deposit special assessment and record it as an asset.

Mr. McGRATH. But wouldn't the people who were doing the accounting there have to point that out to them? I mean, isn't this something that is generally acceptable according to the accountant?

Mr. RIDEOUT. Well, I don't know whether it is generally accepted in terms of the accounting industry, but we don't think—the banking industry does not think it is an acceptable practice.

Mr. McGRATH. Many of us think that since the credit unions have a small universe as compared to the larger universes of your institutions, and since they don't seem to be in any kind of trouble here, it is almost an "if it ain't broke don't fix it" kind of a situation.

Why should we include credit unions in the solution of a problem that haven't contributed to?

Mr. ENGELKE. Why should we include—well, we may not agree here either. As I said before, me and my commercial bank competitors, including Citibank, had an equal amount put into the problem that was created in the first place. So my first thought is that all the help we can get is useful, whoever wants to contribute to this problem.

I didn't cause it, nor did Tom or Maureen here cause the problem in Texas and Florida and California. Had nothing whatsoever to do with it, could not control anything that had anything to do with it.

Mr. McGRATH. That is the point.

Mr. ENGELKE. So any help we could get would certainly will be welcome and Congress should consider getting all that help they can get.

Mr. McGRATH. I guess that your point is that because we are from New York, we should not have to contribute, to the extent that the bill contemplates, as much of a part of the solution as we are asked to, because we were not part of the problem. The analogy is stark when it comes to the credit unions' position on this particular situation.

I don't know what the answer is. I am afraid I am in the same boat as Sam in terms of knowing what the problem is but not knowing what any of the good solutions are.

My time is up. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Engelke, did you want to finish?

Mr. ENGELKE. Yes. Just to continue on that one thought there. We are willing to pay our fair share into this thing as a healthy institution. We are not trying to back away from paying a share at all, and every healthy institution in the country, not one located in certain States. We will pay a fair share. We will pay somewhat more. We understand that we should.

But, as I say, any other help that could be garnered from anybody else would be welcome.

Chairman ROSTENKOWSKI. If there are no further questions—

Mr. RIDEOUT. Mr. Chairman, may I just make a comment on the credit union question. Credit unions, Congressmen, are very effective competitors with banks, in particular, with community banks, and they function in their operations very much as banks. They have branches and the same kinds of services. In fact, they can provide many services that banks are not allowed to provide.

It is our feeling that credit unions, the credit union insurance movement and the fund, etc., should be regulated and operated just as is the case with respect to the bank funds. For instance, the bill contemplates splitting off the Federal Savings and Loan Insurance Corporation from the Federal Home Loan Bank Board, to separate, in effect, the insurer from the charterer and the regulator. We think that would make good sense with the credit unions as well.

And we think it would make good sense with respect to the credit union accounting for their insurance fund and for credit unions themselves to have the same kind of accounting treatment as the banks have. We would urge you to look into that and to consider that.

Chairman ROSTENKOWSKI. Thank you, Ms. Owens. Thank you, gentlemen.

Mr. Bacon. Mr. Stanton. Mr. Selfe. Mr. Eshleman.

Good morning, gentlemen. Thank you for joining us this morning. You all know the procedure here. We allow you to make your 5-minute statement and then we will go into a discussion with you in a question and answer period.

Mr. Bacon, if you would like to begin your testimony, the committee is ready to receive it. Mr. Bacon, would you also identify yourself for the record.

**STATEMENT OF RICHARD L. BACON, ESQUIRE, SONNENSCHN
CARLIN NATH & ROSENTHAL, WASHINGTON, D.C.**

Mr. BACON. My name is Richard L. Bacon. I am a tax partner in the Washington office of Sonnenschein Carlin Nath & Rosenthal, which is a large diversified law firm. A large portion of my practice is in the thrift area and, as a practitioner, I work with some of the troubled savings and loans. I have also worked with investor groups in considering buying troubled savings and loan associations.

I am speaking on my own behalf here today, but that may be partly because of the reluctance of some of the investor groups to publicly come forward. They have asked me to reflect some of their thoughts. I am doing that today, as well as reflecting some of my

own thoughts about the subject of the FSLIC tax benefits that is solely within the jurisdiction of this committee.

By way of background, I have served as a member of the Joint Tax Committee staff and have worked on the tax rules generally for troubled companies. I am not here today to advocate opening up tax shelters or widespread tax abuses by the committee. In 1981, I was outside tax counsel to the Federal Home Loan Bank Board and helped them devise the tax rules that are the subject of this committee's hearing today.

More importantly I have worked with some investor groups that have considered buying insolvent thrifts.

I want to reflect on some of the issues that you have to face in deciding whether to continue these provisions or not. My views are somewhat more technical than some of the other speakers you have heard, but that should not be less useful to you, since Mr. Stark has just introduced a bill, H.R. 1324, to repeal the so-called tax rules. Therefore, it becomes important for us to get into, and be aware of, the technical aspects of what the committee is considering.

You heard some strong accusations in your last hearing on February 22 from the GAO and the Congressional Budget Office about the effect of the FSLIC tax rules in terms of allowing investors to recover their capital quickly, the rules being "unique" and special provisions, and allowing investors to use losses against unrelated income.

My statement makes two points. One is that before you continue on a fast train to uproot these provisions, you might want to appreciate that the tax rules you are dealing with are, in my view, part of general tax policies that we already have in the code for tax free reorganizations and rehabilitating financially troubled companies.

It is going to be quite difficult for you to uproot these, throw them away, without being aware that they reflect policies that you have adopted generally for troubled companies.

Second, some of the aspects of the problems that the GAO and the Congressional Budget Office pointed out to you, some of the tax concerns they have, are not peculiar to these special tax rules that were adopted in 1981, particularly what you have read in the papers about the opportunity for buyers to use these losses against income of nonthrift companies they already own. Those "spillover" tax effects are not part of the specific FSLIC-related tax rules you are considering here today. The spillover rules are part of tax rules we generally have for consolidated tax returns; they have been in the tax regulations a long time and other buyers can realize the same tax effects by acquiring loss companies outside the acquisition of insolvent S&L's.

That doesn't mean that you have to sit still for those provisions. But I do think that if you decide to cut back on any of the tax benefits in supervised mergers of insolvent thrifts, you might want to consider, first, that they are of general scope in the law. Secondly, there may be ways for you to deal with specific concerns, such as the spillover use of pre-merger built-in losses, without throwing the whole baby out. Third, you get into the policy questions, really, of what you want to do with these tax rules. Maybe you should decide to keep the existing FSLIC and FDIC tax rules in place and allow

the regulators to split the tax benefits with buyers as individual circumstances may require.

You have discussed with other witnesses the serious concern you have about how do you raise the money to resolve the insolvent thrift cases. That issue is, who will pay? My concern is a different one: Who will buy? Who is going to buy the institutions that are troubled? I leave it to others to assume that you have raised the money. I would point out that in the Bush plan, of \$74 billion that they have allocated over 10 years for new cases, \$30 billion is devoted to liquidations and \$44 billion is devoted to assisted mergers. That means that even under the administration's plan, once they raise the money, they are going to have to find buyers for these institutions.

Tax incentives may be a way to avoid current cash outlays by the Treasury and also to bring potential buyers to the table. There are, I believe, ways for you to continue tax incentives under tightly controlled circumstances, so that you can carry out the merger aspects of the Bush plan; namely, having raised the money, how do you then find the buyers to come in and take these troubled thrifts off the hands of the Government? There may not be enough healthy thrifts and commercial banks that want to do that.

I can tell you from working with some of the investor groups that I think there are ways you can develop tax incentives, if this is what you are going to insist on calling the FSLIC tax provisions, but still add safeguards and additional restrictions that we can discuss, as a technical matter, to make sure that the abuses you have heard about do not continue to be characteristics of the transactions.

I think you ought to take a careful look at keeping the tax incentives as a way of completing part 2 of the administration's plan, which, as I say, is, after you raise the money, how do you then spend it, and where do you find the buyers to take these institutions back into private ownership.

Thank you.

[The statement of Mr. Bacon follows:]

STATEMENT OF
RICHARD L. BACON

Mr. Chairman and Members of the Committee:

I am tax partner in the Washington office of the law firm of Sonnenschein Carlin Nath & Rosenthal, based in Chicago. I am appearing here today in a personal capacity and not on behalf of any client or group. I have had experience with today's subject in several different capacities. During 1975-1980 I served as a member of the professional staff of the Joint Tax Committee and helped develop the tax provisions which apply generally to reorganizing insolvent and bankrupt businesses, and also the rules for limiting the survival of net operating loss ("NOL") carryovers in corporate mergers and acquisitions.

During 1980-1987 I served as one of the outside tax counsel to the Federal Home Loan Bank Board. In 1981 I worked with the Board to secure enactment of the so-called "FSLIC tax rules" we are discussing today -- the provisions for taxfree treatment of supervisory mergers and treatment of financial assistance from FSLIC as nontaxable.

In 1988 my firm and I worked with a number of private investor groups who submitted bids for various insolvent thrifts and helped structure bids in terms of sharing tax benefits with the FSLIC and planning for the use of tax benefits after an acquisition. I am speaking today in favor of these thrift tax rules even though in several cases the investor groups we advised were not the successful bidder and others were awarded the institutions we bid for. In other cases our groups became frustrated with the process and withdrew their bids.

The public profile of tax benefits in savings and loan rescue mergers has been high mainly because the tax rules were changing for 1989 and many mergers were bunched into the last months of 1988. The Federal Savings and Loan Insurance Corporation's lack of cash also increased the visibility of tax benefits in the deals.

The tax benefits consist of the following:

(1) Interest and principal payments on FSLIC and FDIC notes and agreements for yield maintenance and capital loss coverage are taxfree. IRC § 597.

(2) For tax purposes the rescued thrift continues to use the original cost of its asset and loan portfolio. IRC § 362(b). Since this cost is usually higher than current fair market values, taxable income will not be created after the merger from collections on the loan receivables and other assets, and "paper" losses in the portfolio realized if the assets are sold before they recover value can be deducted on the surviving institution's tax return.

(3) The accumulated past operating losses of the failed thrift can be deducted after the merger so long as the transferred deposits comprise at least one-fifth of total combined deposits after the merger. IRC § 382(1)(5)(F).

These tax benefits have come under heavy fire as "black hat" villains rather than "white hat" solutions to the thrift industry's insolvent cases. Among the criticisms leveled by the Government Accounting Office, the Congressional Budget Office and others are that the tax benefits available to buyers of failed thrifts are unique and "special" in the tax law. They allow investors to shelter income from nonthrift

businesses, recoup their capital too quickly from tax dollars, and gain unfair advantages over healthy competitors. The tax rules are also said to favor buyers who have income from other sources or who can use tax benefits faster than other potential buyers.

Because the tax benefits are viewed as losing tax revenues in unique ways, the administration's S&L reform bill directs that the "cost" of future thrift merger deals include foregone tax revenues. S.413, § 214(3)(f). In the same vein, the Chairman of this Committee insists that further extension of the thrift tax rules must be "paid for."

Rushing to judgment on this subject would, I think, be unwise. The FSLIC tax provisions (which now also cover commercial banks rescued by the Federal Deposit Insurance Corporation) are not "special" or unique. They parallel the tax policies already on the books for insolvent businesses generally and for shareholder contributions to their own corporations. Other difficulties critics have with the tax benefits in thrift deals reflect features common to our tax system as a whole. And perhaps most important, whether the tax benefits are considered special or not, we may find them a useful tool for bringing to the table the needed private capital to meet the Bush Plan's target for resolving new S&L rescues from this point on.

Broadly viewed, much of the adverse publicity surrounding tax results in mergers of insolvent thrifts arises from the fact that, by definition, troubled companies of all kinds suffer losses. Generally, the tax collector prefers to deal with profits or gains where he collects revenue. Losses are the flip side where taxpayers benefit by deducting losses against past or future income. (NOLs can be deducted against income over an 18-year business cycle: 3 years back and 15 years forward). The tax collector becomes stingy about treating losses the same as gains.

The tax benefits in supervisory thrift mergers are large. But to the extent NOL carryovers or pre-merger unrealized losses in the assets are involved, we should remember that these are losses financed with the depositors' own funds; and the depositors' accounts survive the thrift mergers -- not the shareholders of the failed thrifts, whose interests are wiped out. According to FSLIC figures, the total tax benefits involved in 1988 thrift mergers alone over 10 years through 1998 are \$8.5 billion. These numbers need perspective to decide what sort of "cost" to the Treasury they represent and what should be done in the future with the tax rules and with future thrift "resolutions."

Parallel Treatment With Insolvency Reorganizations

Generally. Since the depositors in an insolvent thrift are its creditors, the thrift tax benefits parallel longstanding tax rules for reorganizing insolvent and bankrupt companies generally. The tax law generally permits the creditors of an insolvent or bankrupt regular business to take control of the successor company which obtains a streamlined group of assets after the unproductive assets are disposed of. IRC § 368(a)(1)(G). For NOL carryover purposes, new investors are permitted to buy as much as 50 percent of the stock. IRC § 382(1)(5)(A). The NOL carryovers and tax basis of the insolvent company come over to shelter the first dollars of cash flow from the reorganized business. This in turn makes funds available to repay the creditors ahead of the tax collector.

Thrift mergers follow this same pattern in that the claims of the creditors (depositors) survive in full. Usually they comprise 100 percent of the revamped thrift's deposits. See IRC § 368(a)(3)(D), in effect through 1989.

It is true that creditors must receive stock in an insolvency case, while stock is not issued to the depositors in a thrift deal. Stock would not be issued if two solvent mutual S&Ls merged; yet the IRS has long allowed mergers of that kind to receive the carryover benefits of a taxfree reorganization. See Rev. Rul. 69-3, 1969-1 C.B. 103. The FSLIC tax rules were partly intended to equalize (and equate) mergers of mutual S&Ls and insolvent stock S&Ls. More broadly, in a regular business insolvency, stock is in theory only the method for repaying creditors through dividends from the first dollars of cash flow. Depositors in a reorganized thrift are unique in that they not actually repaid unless and until they ask to be; they do not need formal stock certificates because depositors can always obtain repayment by withdrawing their accounts. But the sheltered cash flow of the new thrift still protects their funds while they are left on deposit.

Agency Assistance. As for making FSLIC or FDIC assistance taxfree, the dual role of the bank agencies as "insurer" and regulator, plus the actual equity interest they take in merger deals, makes the government (in my opinion) the tax equivalent of a shareholder who can assist his company with untaxed contributions, which the company can then spend on deductible expenses. The administration's thrift reform bill, S.413, will specifically allow the Resolution Trust Corporation to take voting or nonvoting stock of any kind in a restructured institution. S.413, § 501. This permission recognizes, in effect, the government's position as a "shareholder of last resort" in the reorganized thrift.

NOL Carryovers. Regarding NOL carryovers, all buyers of loss companies are limited to using NOL carryovers solely against that company's own future income. This "separate return limitation year" (SRLY) rule for consolidated tax returns applies to thrift mergers as well. See Reg. § 1.1502-21(c). It is also less easy to abuse this limitation in a thrift case by dropping unrelated assets into a thrift than to an unregulated business.

Built-in Losses. As for the concern that losses from selling pre-merger assets after a thrift merger can offset income on a combined return filed by a group of companies of which the thrift is a member, there are restrictions on a group's use of so-called "built-in" losses of a new company which joins the group. See Reg. § 1.1502-15. Thrift mergers are governed by these same restrictions. Even if the general restrictions can be satisfied in a thrift deal, the buying group's use of built-in losses is no different for FSLIC deals than for consolidated groups of companies generally.^{2/}

^{2/} In a general bankruptcy reorganization, built-in losses realized by selling assets after the merger can offset unrelated income. Technically, a new investor in a nonthrift company acquired out of a bankruptcy can buy up to 50 percent of the loss company and must wait 3 years and 1 day to buy an additional 30% or more of the loss company from its former creditors. However, this is usually not difficult for the determined investor, and the general 15-year carryover period for NOLs means that the tax benefits will still be available in most cases.

Congress could, of course, change the general rules and limit the use of built-in losses to the acquiring buyer alone, or it might do so for FSLIC deals alone. Perhaps a thrift buyer who belongs to a commonly-owned group of companies should be allowed to use only a gradually increasing percentage of pre-merger economic losses year-by-year after a merger. In any event, the starting point is not a tax benefit unique to thrift mergers.

Buyers With Income Have Inherent Advantages. It is also not unique for some thrift buyers to benefit more than others in their ability to use tax benefits in the form of loss deductions and/or income exclusions. Buyers who bring thrifts into a group of profitable companies can use built-in losses better than buyers who are not part of a group, or who are individuals. This is a fundamental feature of our tax system not limited to thrifts. Tax policymakers have debated for years whether to level the playing field in this regard by "refunding" immediately to all buyers in cash an assumed tax benefit from inherited losses. However, Congress has never seriously considered making immediate cash payments for the tax value of past operating losses. Instead, Congress has preferred allowing losses to produce tax benefits only if, as, and when a business earns income to absorb past losses. Of course, there is always a first time; FDIC might become so flush with cash it can make up-front cash refunds to buyers of thrifts. But in any case, allowing use of prior losses, whether accrued or actually realized, is preferable to extinguishing deductions entirely for losses in failed thrift mergers. That would create an unlevel playing field to the unique detriment of insolvent thrifts.

Recovering Investment From Tax Dollars. A related criticism has been that in some thrift deals, most or all of the capital supplied by new investors has been (or will be) recovered immediately from tax savings resulting from deducting NOL carryovers and other tax losses. Any such result can also occur in a regular insolvency case where (as noted earlier) outside investors can acquire as much as 50 percent stock ownership of the revamped business and use NOL carryovers to recoup, in effect, their capital investment. Nothing unique occurs in FSLIC deals. If Congress desires, one answer may be to increase the capital which investors must put in net of tax benefits or reduce the deduction of losses during the early years after a new investor takes over.

Analogy to LBOs. In many ways the thrift provisions resemble those used in leveraged buyouts which make use of the interest deduction. Many members of Congress are beginning to see that while LBOs could be targeted for special restrictions, they basically use tax benefits broadly available to all taxpayers. As a result, Congress is finding it difficult to deny interest deductions in LBO purchases.

Similarly, the "revenue cost" of the thrift tax rules is not a unique cost of supervisory thrift mergers but is part of the embedded, inherent "cost" of broad general deduction and exclusion provisions of the tax law.

Policy Issue: Should the Thrift Tax Rules Be Kept In Place? Saying that the tax rules for failed banks and thrifts are not unique and are within the ball park of other tax rules for failed companies generally still does not answer the question whether the thrift tax rules should be kept in place as part of the overall rescue plan. If they are not, thrift mergers would be deprived of the "level playing field" that the

tax committees in Congress supposedly want to create for comparable businesses. Also, new negative tax results will occur if failed thrift mergers lose their "taxfree reorganization" treatment. The thrift's past losses would be extinguished even though they were financed with the depositors' own monies. There would be immediate recapture of the thrift's bad debt reserve and, perhaps more painfully, create large amounts of new income in the future ("discount income") as collections are made on mortgages whose tax bases will have been marked down to fair market value at the date of the merger.

As for the criticisms, one possibility is to continue the thrift tax provisions but prevent the "spillover" of tax benefits to a buyer's non-thrift or non-bank income.

Reasons for Retaining Tax Incentives In Failed Thrift Mergers. On the other hand, there may be sound reasons in this emergency to continue using the tax benefits -- which in any case are broadly similar to those for insolvent businesses generally -- to attract private capital from new sources outside the banking or thrift industry to help resolve the problem cases. Reducing tax benefits further, particularly the spillover use of built-in losses, will inevitably drive away many "entrepreneurial" investors, or at least others from outside the industry, and the new capital they can bring in.

At a recent tax conference, FDIC staff indicated that it is considering requiring bidders for failed thrifts to quantify in their bids the tax benefits they expect, with disincentives to "lowball" the expected tax benefits. The effect of the specific techniques to be used, however, may be to discourage rather than encourage buyers for this reason alone.

The Administration's proposal assumes that the Resolution Trust Corporation will merge many of the institutions rather than liquidate all of them. Of the \$74 billion budgeted in the Bush Plan for resolving new troubled thrift cases, \$44 billion is allocated to assisted mergers rather than liquidations. Who will the buyers be? It is far from certain that there are enough other healthy thrifts and commercial banks that will want to buy all the failed thrifts. Congress must decide whether the government will seek to interest "entrepreneurs" (and perhaps even the general public) in bringing new capital into the thrift industry. It may be necessary to attract such new capital with some degree of tax benefits, such as allowing some spillover of tax losses against nonthrift income.

We should note that the thrift tax provisions are essentially neutral on many criticized aspects of the FSLIC deals to date. The tax provisions do not encourage mergers over liquidations (a choice that depends more on whether FSLIC or FDIC has cash in hand to pay off depositors in full). They are neutral concerning the nature of the business of a buyer of a failed thrift, and whether assistance takes the form of cash or a note, and whether assistance is given to a merged thrift or to an "open" bank. Nor do the tax provisions prevent the government from requiring investors to invest real capital net of tax savings or prevent regulators from imposing tighter risk-taking standards on revamped thrifts (or on all thrifts and banks, for that matter).

Also, it does not follow that tax incentives automatically mean that "wheeler dealers" will be allowed to turn thrift rescues into a tax shelter hodgepodge of unrelated businesses. Tax incentives can be controlled to encourage buyers from

outside the industry to fit a bank or thrift into a sensible overall financial services strategy.

Tax Incentives Have Unique Advantages In These Particular Circumstances. Keeping a tax incentive option open also has a unique advantage to the Treasury in terms of cash flow: New owners benefit only as and when they earn income in future years and the government does not have to raise cash up front and pay interest on the cash raised. The government itself is directly negotiating the deals and the sharing of tax benefits. Hence, I think the usual objections to "tax expenditures" (in terms of inefficiency) do not apply here. Unlike the usual criticism of other tax expenditures, the Treasury just does not have the money to substitute direct spending to resolve the thrift crisis.

Further, the government already puts an array of nontax provisions in their merger agreements to encourage buyers to operate a thrift efficiently. New tax safeguards could also be added against a bad faith use of tax incentives, including recapture of tax benefits from a new owner if it is determined that the new investor is not moving fast enough or seriously enough to turn around the rescued thrift. With safeguards, this may be a situation where limited tax incentives can serve socially useful ends.

Proposed Technical Amendments. If this Committee should decide to continue the thrift tax rules after the end of this year, certain technical changes and additions are warranted. I would suggest the following:

(1) The provision in the 1988 Technical Corrections Act allowing taxfree mergers of failed thrifts which do not meet the so-called 60 percent qualifying asset test (in the rules allowing bad debt reserve deductions to thrifts) should be extended to assisted mergers occurring before the end of 1988 -- and not just to those mergers occurring in 1989, as the law presently provides. See IRC § 368(a)(3)(D)(v).

(2) The survival of NOL carryovers should not continue subject to the 20% "cliff" created in the 1986 Tax Reform Act. See IRC § 382(l)(5)(F)(i). The understanding of the industry and the Federal Home Loan Bank Board at the time was that the pre-1986 Act rules for the survival of NOL carryovers in thrift mergers would be continued. Under those rules, if the deposits of the merged thrift did not constitute as much as 20 percent of combined deposits after the merger, NOL carryovers were "scaled down" under a formula that reduced the amount of NOL carryovers by 5 percentage points for each 1 percentage point of depositor continuity less than 20 percent. See former IRC § 382(b)(2), as in effect before the Tax Reform Act of 1986. The 1986 Act created a "cliff," so that if the 20 percent depositor continuity is not met, NOL carryovers become subject to the new annual limitation on using NOL carryovers. The pre-1986 Act "scaledown" should be continued until these rules are terminated.

(3) Where multiple failed thrifts are combined with a single acquirer, the 20 percent depositor continuity requirement for the survival of NOL carryovers should be applied by reference to the entire group of transferred deposits (rather than, as IRS interprets prior law, by reference to each merged institution's deposits separately).

(4) The effect of the Alternative Minimum Tax after 1989, in combination with the existing rule reducing tax attributes

in thrift mergers by 50% of FSLIC or FDIC assistance payments, will in many cases be to reduce nearly to zero any tax benefit Congress intended by exempting agency assistance from tax. The AMT problem will arise from the apparent IRS interpretation of agency assistance as part of earnings and profits in computing "adjusted current earnings" under IRC § 56(g). Tax benefits conferred by § 597 should not be undermined by interpretation of another Code provision.

(5) In 1989, unlike 1988, a mutual thrift's use of its own NOL carryovers and "built-in" losses in its own portfolio is sharply restricted if it converts from mutual to stock form and brings in new public investors. This result occurs under the "segregation" rules of Temp. Reg. § 1.382-2T(j)(2) and (m)(6). This segregation should be eliminated in the interest of encouraging new capital, particularly from the public, to be invested in thrifts.

(6) An S&L (or even FSLIC or FDIC) holding repossessed real estate should be allowed to resell the property to a new owner free of the restriction in present law against a buyer's using seller financing (from the S&L, in other words) in his depreciation of the property. See IRC § 465(b)(6) and § 46(c)(8)(D)(iv)(II). This change would help move problem real estate assets off the books of troubled thrifts, rescued thrifts, or of FSLIC or FDIC itself.

Summary. In sum, the FSLIC tax provisions have a "cost" as does any deduction or taxfree allowance, but not a unique cost to the Treasury. The thrift tax benefits are no more or less a part of the "cost" of thrift rescues than they are for insolvent companies generally. Nevertheless, estimates of the taxpayers' share of the ultimate cost of protecting depositors in failed S&Ls seems to grow by the day. The potential taxpayer cost is growing so large that all bets seem to be off regarding a business-as-usual view of the possible use of the existing thrift tax rules as tax incentives. In this crisis Congress should not throw away any weapon at its disposal, including controlled tax incentives which have real advantages in the present circumstances, to help resolve troubled thrift cases.

- - END - -

STATEMENT OF THOMAS H. STANTON, ESQUIRE, OLWINE,
CONNELLY, CHASE, O'DONNELL & WEYHER, WASHINGTON, D.C.

Mr. STANTON. Mr. Chairman and members of this distinguished committee, my name is Thomas H. Stanton. I am a Washington, D.C., attorney whose practice includes a variety of matters relating to Government-sponsored enterprises and other financial institutions. I am speaking today on my own behalf and not on behalf of any group or client.

The major point I wish to make in my oral testimony is that the Government must apply to Government-sponsored enterprises the financial safety and soundness lessons we have learned from the collapse of hundreds of thrift institutions; otherwise, we are simply shifting our multibillion dollar financial exposure to another set of institutions with similar vulnerabilities.

The decline of the thrift industry will mean greater reliance on Government-sponsored enterprises, especially Fannie Mae and Freddie Mac, that provide a secondary market for an increasing volume of residential mortgages that might once have been held by thrift institutions.

As with FSLIC and Federal deposit insurance generally, the Federal Government implicitly guarantees that Government-sponsored enterprises will not default on their obligations. That means the Government faces substantial financial exposure if it neglects the financial safety and soundness of Government-sponsored enterprises.

Today, the Government implicitly guarantees over \$700 billion—a big number even in Washington terms—in enterprise obligations and securities, almost as large a Federal contingent liability as from FSLIC-insured deposits. Yet Government-sponsored enterprises tend to be even less regulated financially and are subject to less strict capital requirements, if any, than are thrift institutions. Unless this problem is addressed, we risk repeating today's thrift-type problems with a different set of financial institutions.

The similarities between enterprises and thrift institutions are striking. Besides the implicit Federal guarantee that is similar to deposit insurance, enterprises are specialized lenders, specializing in a narrow category of kinds of loans: Fannie Mae and Freddie Mac deal in home mortgages, Sallie Mae deals in student loans, the Farm Credit System deals in agricultural loans, and so forth.

Just as the Federal Home Loan Bank Board failed to regulate thrift institutions effectively, so too we have failed to regulate safety and soundness of enterprises. Enterprises need effective regulation of their safety and soundness comparable to the oversight of their competitors such as banks with federally-insured deposits.

Enterprises should be subject to the kind of risk-based capital requirements and regulatory supervision we are now belatedly imposing on thrift institutions and that we now impose on national banks. Preferably regulation of safety and soundness of all enterprises should be centralized in a single regulator similar to the Comptroller of the Currency.

Just as with federally-insured banks and thrifts, regulation is needed because the implicit Federal guarantee of enterprise borrowing weakens market discipline and creates considerable incen-

tive to take risks. Economists call this moral hazard. Private institutions can profit from risky ventures but the U.S. taxpayer pays for the big mistakes.

As the plight of the thrift industry has taught us, effective regulation is essential to protect the Government against substantial exposure from risky lending. Risk-taking can take a variety of forms. In the late 1970's, for example, Fannie Mae made the mistake of many thrift institutions and funded a large portfolio of long-term mortgages with short-term borrowings. When interest rates rose Fannie Mae's finding mismatch resulted in a market value negative net worth of almost \$11 billion by 1981. Only energetic new management strategies and declining interest rates saved the enterprise from calamity.

This committee was also called upon to help and granted Fannie Mae a special tax provision in the Miscellaneous Revenue Act of 1982.

The Farm Credit System was not as lucky. Again, abetted by the implicit Federal backing, farm credit institutions undertook substantial interest rate risks and credit risks and failed to price loans properly. When the agricultural economy went into decline, the Farm Credit System announced it could not meet its obligations.

This, then, is the ultimate similarity between enterprises and thrift institutions. Unsafe and unsound practices can lead to demands for the Government to make good on its implicit guarantee. Congress has now established a \$4 billion off-budget program, the Financial Assistance Corporation, to pay for the restructuring or closing of farm credit institutions. This funding device is a very close model for the Resolution Funding Corporation that the administration has proposed to pay for failed thrifts.

Fortunately, most enterprises have been well run despite the moral hazard created by the implicit Federal guarantee. The problem is that, just as was true of thrifts, the legal confinement of enterprises to funding specialized kinds of loans, home mortgages or student loans or agricultural mortgages, for example, means that profitability today cannot assure financial soundness tomorrow.

Because of the lack of diversity, one systematic problem with credit risk or interest risk or inadequate management systems can suddenly translate into substantial financial damage. It is time now, before another enterprise gets into trouble, to institute effective regulation of safety and soundness.

I will leave to my written testimony a second point which is that it is expensive and wrong to use a Government-sponsored enterprise as an off-budget device to finance FSLIC. Quite simply, the choice is not whether we put funding of FSLIC on or off budget. The question is whether we create a Government-sponsored enterprise that will cost literally billions of dollars more over the next 30 years, or do we instead fund through Treasury borrowing, the cheapest way possible, or direct assessments, if necessary, and then make a simple determination whether this will go on or off budget the way that, for example, the Federal Financing Bank has been changed in its budget treatment.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Stanton.

[The statement of Mr. Stanton follows:]

Statement of

Thomas H. Stanton

March 9, 1989

Government Sponsored Enterprises and the Federal
Response to the Insolvency of the Federal
Savings and Loan Insurance Corporation (FSLIC)

Mr. Chairman, Members of the House Ways and Means Committee:

Thank you for the invitation to testify today on the federal response to insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). My name is Thomas H. Stanton and I am a Washington, D.C. attorney whose practice includes a variety of matters relating to government sponsored enterprises and other financial institutions. I am speaking today on my own behalf and not for my law firm or for any client.

The House Ways and Means Committee is to be commended for holding these hearings. It will be the American taxpayer, through actions taken by this committee, that will somehow pay much of the ultimate cost of the federal government's liability for FSLIC. The various financing devices that have been proposed to aid FSLIC will change the timing and amount of those payments.

In my testimony today, I would like to address two issues concerning government sponsored enterprises. First, the decline of the thrift industry will mean greater reliance on enterprises, especially Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) that provide a secondary market for an increasing volume of residential mortgages that once might have been held by thrift institutions. Also, increasing concern about interest rate risk and application to banks of significant risk-based capital requirements may mean that the credit markets increasingly rely on other government sponsored enterprises for other kinds of loans as well.

As with FSLIC and federal deposit insurance, the federal government implicitly guarantees that enterprises will not default on their obligations. That means the government faces substantial financial exposure if it neglects the financial safety and soundness of government sponsored enterprises. Today the government implicitly guarantees over \$700 billion in enterprise obligations and securities -- almost as large a federal contingent liability as from FSLIC-insured deposits. Yet, government sponsored enterprises tend to be even less regulated financially and are subject to less strict capital requirements (if any) than are thrift institutions. Unless this problem is addressed, we risk repeating today's thrift-type problems with a different set of financial institutions.

Second, it has been proposed that the government create a new government sponsored enterprise to be called the Resolution Funding Corporation (REFCO), to issue at least \$50 billion in bonds to fund FSLIC. This device will cost taxpayers literally billions of dollars more than if FSLIC were funded through direct Treasury borrowing. Moreover, such a device clearly and unambiguously violates the governing budget principles that were estab-

lished by the 1967 President's Commission on Budget Concepts. Congress is free to decide whether to place FSLIC funding on- or off-budget -- just as Congress has changed the budgetary status of the Federal Financing Bank and other federal financial institutions over time. However, a government sponsored enterprise is an expensive and improper way to deal with the federal budget question.

Government sponsored enterprises and their activities involve a substantial contingent liability for the federal government. Yet, by focusing on them, I do not wish to argue that enterprises are somehow illegitimate instruments of federal policy. I personally find the government sponsored enterprise to be an appropriate way for the government to serve those public purposes for which such an institution is well suited. My concern is that, like other federal instrumentalities such as federally-insured thrift institutions, the enterprises must be structured, capitalized, and supervised to assure that their public benefits outweigh the potential costs.

- I. The government must apply to government sponsored enterprises the financial safety and soundness lessons from FSLIC's insolvency. Otherwise the government is simply shifting its multibillion dollar financial exposure to another set of institutions with similar vulnerabilities.

It is time to shore up the other major government program with liability similar to federal deposit insurance -- the system of government sponsored enterprises. Enterprises differ from thrifts primarily in their immense size: Fannie Mae, Freddie Mac and the Federal Home Loan Bank System each fund or guarantee well over a hundred billion dollars of loans. Sallie Mae, one of the smaller enterprises, is a \$26 billion institution growing at about 20% per year.

Except for size, the similarities to the thrift industry are striking. Just as the federal government provides federal insurance for thrift deposits, it provides an implicit guarantee of enterprise borrowing that significantly reduces their cost of funds. Like thrifts, enterprises are specialized lenders: Fannie Mae and Freddie Mac purchase home mortgages, Sallie Mae funds student loans, the Farm Credit System deals in agricultural loans, the Federal Home Loan Banks lend to thrift institutions, and the Financing Corporation (FICO) is used to help bail out FSLIC. Like many thrifts, enterprises are federally-chartered, privately-owned institutions.

Unfortunately, there is another similarity between thrifts and enterprises. Just as the Federal Home Loan Bank Board failed to regulate thrift institutions effectively, so too the government has failed to regulate safety and soundness of the enterprises. The U.S. Department of Housing and Urban Development, Fannie Mae's regulator, lacks the capacity or expertise to

¹ For a discussion of the implicit federal guarantee and government sponsored enterprises, see e.g., Michael Moran, "The Federal Sponsored Credit Agencies: An Overview," Federal Reserve Bulletin, Vol. 71, No. 6, pp. 373-378 (June 1985); and Thomas H. Stanton, "Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy," pp. 1-8, 17-18 (1988).

oversee the financial condition of Fannie Mae and its \$266 billion in mortgage loans and securities. The Federal Home Loan Bank Board (FHLBB) is Freddie Mac's board of directors as well as its regulator and also oversees the Federal Home Loan Banks and FICO. The FHLBB faces a serious conflict of interest with its responsibilities for troubled thrifts and has been tempted to use Freddie Mac and the Federal Home Loan Banks in that effort, rather than concentrating on the enterprises' safety and soundness. The Farm Credit Administration (FCA) regulates the farm credit institutions including the new Farmer Mac. Before 1985 it lacked independence from the regulated farm credit institutions; the government only turned the FCA into a serious financial regulator after the Farm Credit System lost billions of dollars. Sallie Mae has no financial regulator at all.

Enterprises need effective regulation of their safety and soundness, comparable to the oversight of their competitors such as banks with federally insured deposits. Enterprises should be subject to the kind of risk-based capital requirements and regulatory supervision the government requires for national banks. Preferably, regulation of safety and soundness of all enterprises should be centralized in a single regulator with responsibilities, powers, and capabilities similar to those of the Comptroller of the Currency.

Just as with federally insured banks and thrifts, regulation is needed because the implicit federal guarantee of enterprise borrowing weakens market discipline and creates considerable incentive to take risks. Economists call this "moral hazard"; private institutions can profit from risky ventures but the U.S. taxpayer pays for the big mistakes.

The implicit federal guarantee means that investors can look to the government rather than to an enterprise's creditworthiness for assurance that their investment will be repaid. Federal backing thereby permits management to engage in risky activities without fear of driving away investors or having to pay prohibitive rates of interest to attract funds. As the plight of the thrift industry has taught us, effective regulation is essential to help protect the government against substantial exposure from risky lending.

Risk taking can take a variety of forms. In the late 1970's, for example, Fannie Mae made the mistake of many thrift institutions and funded a huge portfolio of long-term mortgages with short-term borrowings. When interest rates rose, Fannie Mae's funding mismatch resulted in a market value negative net worth of \$10.8 billion by 1981. Only energetic new management strategies and declining interest rates saved the enterprise from calamity. This committee also helped Fannie Mae, with a tax provision in the Miscellaneous Revenue Act of 1982.

The Farm Credit System (FCS) was not as lucky. Again abetted by the implicit federal backing, FCS institutions undertook substantial interest rate risk (this time funding short-term lending with longer-term borrowings) and credit risk, and failed to price loans properly. For example, by 1981 FCS institutions were offering farm borrowers loans at rates of interest five percentage points below competing rural lenders. When the agricultural economy went into decline, the FCS announced it could not meet its obligations.

This, then is the ultimate similarity between enterprises and thrift institutions: unsafe and unsound practices can lead to demands for the government to make good on its implicit guarantee. Congress has now established a \$4 billion off-budget program, the Financial Assistance Corporation, to pay for the restructuring or closing of farm credit institutions. This funding device is a model for the Resolution Funding Corporation proposed to pay for failed thrift institutions.

Fortunately, most enterprises have been well run despite the "moral hazard" created by the implicit federal guarantee. The problem is that, just as was true of thrifts, the legal confinement of enterprises to making specialized kinds of loans -- home mortgages or student loans or advances to thrift institutions, for example -- means that profitability today cannot assure financial soundness tomorrow. Because of the lack of diversity, one systematic problem with excess credit risk or interest risk of inadequate management systems can suddenly translate into substantial financial damage. It is time now, before another enterprise gets into trouble, to institute effective regulation of safety and soundness.

II. It is expensive and wrong to use a government sponsored enterprise as an off-budget device to fund FSLIC.

It has been proposed to use a government sponsored enterprise called the Resolution Funding Corporation to provide federal financial assistance to the insolvent FSLIC. The new enterprise would issue \$50 billion of debt obligations, or perhaps more, to raise money for FSLIC. Those obligations would carry an explicit government guarantee of interest, as well as an implicit government guarantee of the principal. Economists point out that this form of debt financing is significantly more expensive for taxpayers than direct borrowing by the Treasury and that it would add literally billion of dollars to the cost of assisting FSLIC. The chief virtue of the enterprise appears to be the belief that it can fund FSLIC without having the Corporation and its losses promptly appear on the federal budget.

In fact, losses from operations of REFCO should be reported as part of the federal budget. Such a result is dictated by the test of the 1967 President's Commission on Budget Concepts that an enterprise be considered off-budget only when it is "completely privately owned."² It is widely accepted that the 1967 Commission criterion should determine whether a financial institution is on or off of the budget.³ As is explained below, placing REFCO on-budget does not require any change in the off-budget status of the traditional government sponsored enterprises such as Fannie Mae and Freddie Mac. However, application of the "complete private ownership" test does require that FICO, the

² Report of the President's Commission on Budget Concepts, p. 30, October 1967.

³ See, e.g., the Budget of the United States Government, FY 1990, Special Analysis E, pp. E-39 and E-40.

enterprise recently created to provide federal financial assistance to FSLIC, be placed on-budget. The enterprise created to fund the insolvent Farm Credit System, called the Financial Assistance Corporation (FAC), is already on-budget for other reasons.⁴

REFCO clearly and unambiguously fails the private-ownership test of the 1967 Commission on Budget Concepts. It is a well-settled principle of law that the owner of property is the person or entity that has the right to use and enjoy the benefits of that property and that bears the risk of loss from the property.⁵

REFCO benefits the government; its only purpose is to raise funds for the government to close insolvent thrift institutions by paying off creditors. The government, through a federal institution known as the Resolution Trust Corporation, would control the decisions about how and when to use money from REFECO. REFECO is essentially a shell corporation. Under its statutory structure, it is virtually impossible for REFECO to have a positive net worth. The federal government implicitly guarantees the principal of REFECO obligations and explicitly guarantees the interest, and will be called upon to pay off REFECO creditors in case of any default.

The nominal contributors of private money, the Federal Home Loan Banks, have no right to enjoy the benefits of the property or to decide how REFECO's corporate assets will be used. They did not make an investment and will not profit from their contribution. Their contribution is mandated by law and will be determined by law as administered by a board of federal officials. This is a mandatory and involuntary assessment that is unlikely to be rebated. It is the government that owns REFECO because the government allocates the benefits of the corporation and is responsible for the losses.

The same logic applies to the Financing Corporation (FICO) of the Federal Home Loan Bank System, established in 1987 to provide funds for FSLIC, and the Financial Assistance Corporation (FAC), established in 1988 to provide funds for the Farm Credit System.⁶ On the other hand, this logic does not affect the budgetary status of the traditional government sponsored enterprises, Fannie Mae, Freddie Mac, Sallie Mae, the Federal Home Loan Banks, the Farm Credit System, and the new Federal Agricultural Mortgage Corporation. In contrast to FICO and FAC, the traditional

⁴ Budget of the United States Government, FY 1990, Special Analysis E, p. E-40.

⁵ See e.g., Brown, *Treatise on the Law of Personal Property*, § 5, and Tiffany, *The Law of Real Property*, Vol. I, § 2. See also, e.g., *American Motors Corporation v. City of Kenosha*, 80 N.W. 2d 363 (Wisc., 1957), affirmed 356 U.S. 78 S.Ct. 559, rehearing denied 357 U.S. 912, 78 S.Ct. 1147.

⁶ For more detailed analysis, see, Testimony of Thomas H. Stanton, "Budgetary Consequences of Using a Government Sponsored Enterprise to Provide Financing Assistance to the Federal Savings and Loan Insurance Corporation," submitted to the House Committee on the Budget, February 3, 1989.

enterprises generally allocate their corporate benefits and make their loans under direction of managers who make profits for private owners and pay them dividends.

While the federal government does bear risk of loss from enterprise activities, as noted above, this is analogous to the government's financial exposure when it insures deposits for privately-owned commercial banks and thrift institutions. Unlike REFCO, FICO, and FAC, that are designed to be commercial failures from their inception, the traditional enterprises are structured so there is significant likelihood they can make money for private owners.

Unless the principles of the 1967 Budget Concepts Commission essentially are to be disregarded, REFCO should be placed within the federal budget. The government is free to enact legislation expressly removing any government corporation from the budget, but the budget process loses integrity and value as a management tool if artificial and sham transactions are used instead.

Thank you.

Chairman ROSTENKOWSKI. Mr. Selfe.

STATEMENT OF EDWARD M. SELFE, VICE CHAIRMAN, SECOR BANK, FEDERAL SAVINGS BANK, BIRMINGHAM, ALABAMA

Mr. SELFE. Yes, sir. Thank you, Mr. Chairman.

I am vice chairman of Secor Bank, Federal Savings Bank. It is a \$2.7 billion savings bank. The headquarters are in Birmingham, Alabama, with 59 branches in Alabama, Louisiana, and Florida.

We have been active in the acquisition of insolvent thrifts and we want to continue, and I would like to give you a little information about what happens when we acquire an insolvent thrift.

Now the reason that I think you should continue these tax rules is to encourage people like Secor Bank to be out there making these acquisitions. If you close down all of the insolvent institutions, that is, insolvent in accordance with generally accepted accounting principles, it will take you \$100 billion of cash today.

The Bush plan does not contemplate paying out that amount of cash today. That means you must be planning for profitable thrifts to acquire and manage these insolvent thrifts. These tax rules facilitate that.

I will give you a simple example. If you have an insolvent thrift with \$1 billion of deposits and \$1 billion of assets that it paid \$1 billion for but have a fair market value of only \$500 million, you have got a \$500 million deficit. If you close that institution, you must pay out \$1 billion in cash today. If you let us acquire it, you pay out only \$500 million. Now that is the classic example, and these tax rules encourage us to do it.

Now the particular rule is a carryover of an operating loss of an insolvent thrift. That is a deduction, as you gentlemen know; it is not a credit. It can only be used if the acquiring company makes a profit in the future. Whether or not it will make a profit is uncertain, and today that is maybe hard going with the interest rates going up. But it is not dollars in hand. It is an inducement for us to come in and make the acquisition.

The other inducement really is we want those branch operations and we are willing to negotiate with your FDIC or FSLIC to do that.

Now it has been suggested that there is no competition out there for these insolvent thrifts. That is not our experience. In 2 years we have submitted bids for 25 institutions and we have obtained five. Three of those were by what is called a supervisory merger, two of them where we bought the deposits by assuming those liabilities.

Now in only one of the supervisory mergers did we get the benefits of any carryovers. In the other two we did not because they were too small. As you may know, under the rules you cannot use the carryover of an insolvent thrift unless its deposits represent at least 20 percent of the combined deposits and net worth of the acquiring company. So you don't get them every time.

But it is important, in my judgment, for the Congress to encourage the Secor Banks of this country to get in there and take over these institutions because we do this. We have an effective and efficient staff that can manage those assets. When you take over, if

you were going to close them down, \$100 billion of cash that you pay out, you now have about \$200 billion of assets located in 50 different States that you must manage. And, if you don't manage those effectively, you are going to lose a lot more than \$100 billion.

So when you have got a whole group of capable profitable institutions out there who want to do it and who can do it, you should encourage that, and that is what these tax rules do.

Now it does not seem to me to be unreasonable for losses incurred in the thrift industry to be available for use against future profits in the thrift industry. I understand and agree that they shouldn't be deductible against the manufacturing profits of automobiles, but you can easily remedy that. That is not a difficult problem.

Although there is a change in ownership of the loss, if so long as the loss is being used against future thrift industry profits, it does not seem to me improper, even though there has been a change of ownership. So it facilitates the solution of this problem to encourage the profitable, effective, efficient institutions to get in here and help you.

In our organization is mostly Certified Public Accountants, masters of business administration, and lawyers. It is a very capable organization, and there are lots of others around here that way. So I encourage you to extend these tax rules.

You know, you are going to run into another deadline. Everything is on hold right now. At the end of 1988 we had four bids out there that were just sitting there. We are ready to move, but nothing is going to happen for months. And you are going to run right up into December 1989 again unless these rules are extended.

[The statement of Mr. Selfe follows:]

EDWARD M. SELFE
Vice Chairman

SECOR Bank, Federal Savings Bank
201 Office Park Drive
Post Office Box 12087
Birmingham, Alabama 35202-2087
205-877-0200



January 27, 1988

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Tax Rules Relating to Mergers of
Savings and Loan Associations

Dear Mr. Leonard:

We urge that the tax rules applicable to mergers of savings and loan associations ("association") be continued and extended beyond 1989. These tax rules include the following provisions:

1. Tax-free Receipt of FSLIC Payments. FSLIC payments received by an association pursuant to Section 406(f) of the National Housing Act (U.S.C. Sec. 1729(f)), are excluded from gross income and cause no reduction in basis pursuant to Sec. 597 of the Internal Revenue Code ("Code").
2. Association Mergers Qualify as Reorganizations. A supervisory merger of an insolvent association into a profitable association is treated as a "G" reorganization. Sections 368(a)(3)(D)(ii) of the Code.
3. Carryover of Tax Losses. Subject to certain limitations and offsets, built-in losses and operating losses of an insolvent association may be used by the acquiring association if the deposits of the insolvent association represent at least 20% of the deposits and equity of the combined association. Section 382(L)(5) of the Code.

These provisions encourage profitable associations to acquire insolvent associations thereby relieving FSLIC of the additional cost and burden of liquidating the insolvent association. FSLIC will provide sufficient financial assistance

in the form of cash, promissory notes and contractual obligations to eliminate a deficit in the net worth of an insolvent association. Such financial assistance is not sufficient to induce a profitable association to assume the risks and burdens of acquiring an association with a zero net worth unless tax benefits or other benefits are acquired.

The cost to FSLIC of a supervisory merger may not always be substantially less than the cost of liquidating an insolvent association but liquidation requires an amount of cash which is not now available to FSLIC. For example, assume an insolvent association has assets with a book value of one billion dollars and a fair market value of 500 million dollars, and deposit liabilities of one billion dollars resulting in a deficit net worth of five hundred million dollars. Closing the insolvent association by a liquidation would require an immediate outlay of one billion dollars in cash by FSLIC.

On the other hand if the insolvent association is merged into a profitable association and most of the FSLIC assistance is in the form of promissory notes and contractual agreements the cash outlay can be greatly minimized. A supervisory merger can often be less costly than liquidation in present value terms.

Merging an insolvent association into a profitable association will require FSLIC to pay market rates of interest on its obligations to the profitable association, and this rate of interest may be higher than the rate on comparable treasury notes or bonds. Nevertheless, the merger approach permits FSLIC to defer paying immediately the more than 100 billion dollars which would be required to liquidate immediately all the existing insolvent associations.

Mergers of insolvent associations into profitable associations will result in lower income taxes for the profitable associations in future years if the net operating loss carryovers and built-in losses can be used by the profitable association. Under the SRLY rules, operating loss carryovers can only be used to offset the taxable income of the acquiring association. Built-in losses can be used to offset taxable income of affiliates of the acquiring associations under certain conditions. But the use of either loss carryover requires that the profitable association or its affiliates have sufficient taxable income after the acquisition to benefit from the operating and built-in losses before such tax benefits expire.

Since the operating and built-in loss carryovers can only be used against future profits, it is difficult to place a present

value on such tax benefits. The merger procedure permits FSLIC to negotiate the value of such tax benefits with the profitable association that is acquiring an insolvent association.

Extending thrift industry tax rules will give FSLIC a bargaining position in negotiating insolvent association mergers. It will result in profitable associations having to compete with each other in determining what part of the thrift industry losses will be used for the benefit of FSLIC.

If insolvent associations are to be closed by liquidation rather than merger, the federal government will have the enormous burden of managing and disposing of all the assets of the insolvent associations. There is no federal agency with the personnel and expertise to do this, but associations such as Secor Bank are capable of doing so.

If the Congress does not wish losses incurred in the thrift industry to be used to offset profits from non-thrift business activities such as the manufacture of automobiles, this can readily be accomplished. Appropriate legislation can be enacted to limit the use of such losses to the thrift industry. FSLIC itself can limit the use of these tax benefits to the thrift industry as it did in the case of the Bass acquisition of American Savings Bank.

The Congress should encourage the merger of approximately 300 insolvent associations into the approximately 2,000 profitable associations. This will assure that thrift industry losses will be used only to offset future thrift industry profits. In addition, it will mean that insolvent associations are acquired by experienced and successful thrift industry operators.

Investors who bring new capital into the thrift industry will be able to use thrift industry losses against future thrift industry profits including the profits from the new capital invested in the industry. There should be no objection to encouraging the use of thrift industry losses against future thrift industry profits earned by new investors since the thrift industry is being asked to make a substantial financial contribution to the resolution of the present crisis.

Most governmental and thrift industry commentators have concluded that the cost of removing the insolvent associations from the industry must be born by the taxpayer. The most effective way to accomplish that is to make the present thrift industry losses available for use by profitable associations.

It will take many years for the profitable associations to use all of the 100 billion dollars of existing losses of the thrift industry. This means that the cost to the taxpayer will be spread over the next fifteen years to twenty years. It will also mean that Gramm-Rudman budget targets will not be encumbered with the current financial problems of the thrift industry.

We urge the continuation and extension beyond 1989 of the existing tax rules applicable to the merger of savings and loan associations, and recommend that the twenty percent (20%) test of Section 382(L)(5) be reduced to ten percent (10%).

Respectfully submitted,

SECOR BANK, FEDERAL SAVINGS BANK

By Edward M. Selfe
Edward M. Selfe
Vice Chairman

Chairman ROSTENKOWSKI. Thank you, Mr. Selfe.

Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Chairman, I want to take this opportunity to welcome to Washington and to the committee, Mr. Dick Eshleman, who is the president and chief executive officer of one of the outstanding institutions in my judgment in Pittsburgh, and certainly in Pennsylvania, and let him know that we are happy to have him here, and look forward to the testimony that he is about to give.

Thank you.

Chairman ROSTENKOWSKI. Mr. Eshleman.

**STATEMENT OF J. RICHARD ESHLEMAN, PRESIDENT AND CEO,
LANDMARK SAVINGS ASSOCIATION, PITTSBURGH, PA.**

Mr. ESHLEMAN. Mr. Chairman, my name is J. Richard Eshleman, I am the president and chief executive officer of Landmark Savings Association, headquartered in Pittsburgh, Pennsylvania.

I am not here to plead for a personal bailout. Landmark is one of the many healthy and sound thrifts. Last year in the midst of the crisis that rocked the financial industry, Landmark made the most profit in its history, and its credit quality is excellent.

I come as a representative of the hundreds of institutions that have rightfully earned the trust of their depositors and investors, and they earned the right of your trust.

I agree with the general direction of the Bush plan toward internal reform. Higher capital requirements and the eventual elimination of good will are desirable goals. I implore this committee to consider, however, two criticisms of the plan.

First, the proposed source of relief does not have a broad enough base. Second, the standards and timetable for reform are dangerously unrealistic. The Bush plan puts too great a burden on the thrift industry as a source of funding. Keep in mind that in addition to approximately 350 insolvent thrifts, there are hundreds more at the margin. The plan would require significantly higher insurance premiums, and these substantial premium increases will drive the marginal institutions toward a new group of insolvents.

The Bush plan presumes that a rapid rise in the number of deposits will cover the extra premium cross. The plan assumes a 7.2 percent annual growth rate in savings deposits. This is unrealistic. Even when we are in a savings mood, the increase in annual savings rates of Americans over the past 5 years approximates only 2 or 3 percent. We must seek a broader base to spread the burden. Otherwise, the rescue of thrifts will become as futile as chasing the horizon.

One place to look is the loan side of operations, the entire mortgage delivery system. Such an approach should involve the secondary market agencies. One possible method of achieving this would be a nonburdensome surtax on the guarantor fee income of Fannie Mae and Freddie Mac.

Secondly, consideration should be given to a broad base fee on the extension of new mortgage credit. Such a fee would by necessity include all grantors of mortgage credit whether they be thrifts,

commercial banks, credit unions, mortgage bankers, or insurance companies.

These institutions would receive credit for such fees toward the deposit insurance premiums when they exceed 15 basis points.

The ultimate goal of this rescue effort must be rehabilitation rather than confiscation. Confiscatory funding plans would cause more insolvency, fewer tax paying institutions, and less Federal revenue.

My second criticism of the Bush plan involves mandates and timing, how and when. The Bush plan asks thrift institutions to meet the capital requirements of banks. This would mean an increase in the capital requirement from the present 3 percent to about 6 percent or more by June of 1991.

Right now Landmark's capital exceeds industry standards by 40 million. If Landmark were required to meet a 6 percent capital requirement in just 2 years, it would have one of two choices. First, we would have to raise an additional \$24 million in new capital through equity margins. What would entice future investors to make such an unprecedented purchase of new shares in this present dismal environment?

Our second choice would be to shrink our \$1.9 billion of assets by \$500 million. Of course, if we shrink our earning power to support tax payments and FSLIC premiums diminishes. Even more disturbing is the prospect of a national fire sale of thrift assets. If capital requirement is increased to quickly, I can assure the members of this committee that they will be sitting here in 1991 with yet another and even worse problem with which to deal.

If the deadline were extended to June of 1993, the Nation's healthy thrifts would be far more capable of meeting Federal guidelines, paying insurance premiums and income taxes, and thereby contributing to the solution rather than to the problem.

A similar situation exists with the plan's requirement for eliminating good will as a capital item. If the retirement deadline is cut in half to just 10 years, Landmark's income will be cut roughly in half, not exactly an enticement for the capital markets to make a significant additional investment.

As constructed, the plan will reduce Federal revenues from the thrift industry. It would far wiser to let the industry have enough time to strengthen itself. On behalf of the honest, well-managed, successful thrift institutions of America I ask you to consider the fiscal consequences of these proposals and to fashion a prudent solution to this industry's dilemma.

Thank you.

[The statement of Mr. Eshleman follows:]

Testimony of J. Richard Ehleman
President and CEO, Landmark Savings Association
before the
House Ways and Means Committee
March 9, 1989

Mr. Chairman, Members of the Committee. My name is J. Richard Ehleman, and I am president and chief executive officer of Landmark Savings Association, headquartered in Pittsburgh, Pennsylvania. Landmark is the 170th largest thrift in the country. I am honored to be here today to address this Committee on the vital issue of proposed reforms for the thrift industry. I firmly believe that the investigatory function of Congress is an essential part of enlightened policy making. For this reason, I am grateful to have the chance to speak as a member of the thrift industry to offer my and my institution's perspective on the present crisis. Landmark Savings — and by that I mean our shareholders, depositors and employees — has a direct stake in the outcome of your deliberations.

I will not recap the history of the crisis in the thrift industry. There has been no shortage of discussion of that issue in Washington, or anywhere else, for that matter. This Committee knows that reform is imperative. I agree. But what form will that reform take? What effect will it have? Here, there is no consensus, and here I wish to enter the debate.

I am not here to plead for a personal bailout. Landmark is one of the many thrifts that are healthy and sound. Landmark is healthy, sound, well-managed and in business for the long-run. Last year, in the midst of a crisis that rocked the financial industry, Landmark had the best year in its history. I am proud of the fact that our institution had net income of \$8.7 million in 1988, representing a 23 percent increase over the previous year. Landmark's credit quality is excellent.

The reason I am here today is to discuss the present proposals from two perspectives: how they will affect the healthy segment of our industry, and how they will affect your prime concern — the integrity of the nation's treasury. We must examine President Bush's plan in this context.

Our institution has had a steady record of growth, recording five straight years of increased earnings. This goes back to the very origin of Landmark Savings, when it was formed in 1982 by the merger of four thrift institutions in the Pittsburgh area. We have never had a brokered deposit, nor have we engaged in speculative ventures.

However, I must remind the Members of this Committee that Landmark's success did not come without a struggle. Until 1982, thrift institutions were prohibited from offering adjustable-rate loan products. This prohibition in conjunction with escalating deposit interest rates caused Landmark to lose \$80 million. We have recovered that loss and are back on solid ground, but only after hard work and strong management. We are doing well, but we have not forgotten the pain that can result from government action that is sometimes too late or sometimes too abrupt.

This introduction should give you a proper perspective on Landmark's position toward proposed thrift reforms. I do not come to you with hat in hand. I come as a representative of the thousands of institutions that have rightfully earned the trust of their depositors and shareholders. And have earned the right to yours.

The Bush proposal is an excellent first step. I agree that the prosperous institutions, like Landmark, need to assume some of the burden of relief for our industry. We are eager to contribute to the national effort to save the thrift industry. Indeed, we already have seen our insurance premiums triple since 1985. We'll continue to do our part.

I also agree with the general direction of the Bush proposal toward internal reform. Higher capital requirements and the eventual elimination of goodwill as an asset are desirable goals. I beg this Committee to consider, however, two criticisms of the Bush plan.

- o First, the proposed source of relief does not have a broad enough base.
 - o Second, the standards and timetable for reform are dangerously unrealistic.
- Let me examine each of these criticisms in turn.

Broadening the Base:

The Bush proposal puts too great a burden on the thrift industry as a source of relief funding. Keep in mind that in addition to the approximately 350 insolvent savings institutions targeted by the Bush plan, there are hundreds more at the margin. The Bush plan would require significantly higher insurance premiums and will drive marginal institutions into the insolvent category. They won't be able to pass on the costs of their premiums and expect to remain viably competitive.

The Bush plan presumes this won't happen, because it assumes that a rapid rise in the number of deposits will cover the extra premium costs. If this assumption were true, we might have cause for optimism. But, of course, it isn't. The plan assumes a 7.2 percent annual growth rates for savings deposits. I would refer this Committee to the fact that we have experienced more than a two percent net loss in deposits since last November.

Even if all that money returns to thrifts once the dust settles, the 7.2 percent growth rate is unrealistic. Since 1984, individual savings in this country actually fell from \$164 billion a year to \$146 billion a year.

Even when we're in a saving mood, the increase in the annual rate averages out to around two or three percent over any period of more than a couple years.

My fear is that a vicious cycle could be generated. As marginal thrifts buckle under the burden, the weight will increase on those that remain. These thrifts will have to pay even higher premiums, threatening more institutions with insolvency. All this while simultaneously being asked to double their capital reserves within two years. Soon, even the Landmarks of this world would be stretched to the breaking point.

We must mitigate the impact of drastically increased insurance premiums on the thrift industry. We must seek a broader base of relief to spread the burden. Otherwise, the rescue of S&Ls will become as futile as chasing after the horizon. The faster we move toward it, the faster it will move away.

I think there are ways to find sufficient funding without adversely affecting the budget, the consumer or the taxpayer. This Committee must endorse creative methods for raising revenues and increasing the number of participants in the relief effort.

One place to look is the loan side of the equation — the entire mortgage delivery system.

Such an approach should involve participation of the secondary market agencies. One possible method of achieving this participation would be a surtax on the amount of guarantor fee income earned by Fannie Mae and Freddie Mac. In addition, consideration should be given to a broad-based fee on the extension of new mortgage credit. Such a fee would, by necessity, include all grantors of mortgage credit, whether they be thrifts, commercial banks, mortgage bankers or insurance companies. These institutions would receive credit for such fees when deposit insurance premiums exceed 15 basis points.

This kind of mechanism could raise revenues from the financial industry as a whole without crippling any single segment of it. The ultimate goal of this rescue effort must be rehabilitation, rather than confiscation. Confiscatory funding plans will cause more insolvencies, fewer taxpaying institutions, and less federal revenue. As custodians of the national budget, the Members of this Committee must realize the need for a long-range and broadly based approach toward funding the rescue of this segment of the financial industry.

Realistic Standards and Timetable:

My second criticism of the Bush plan involves mandates and timing. Higher capital requirements and the elimination of goodwill as an asset are each worthy goals. The important question is how, and when. I am afraid the President's proposal asks for too much too soon.

First, let me speak about capital requirements. The Bush plan asks thrift institutions to meet the standards of banks. This would mean an increase in the capital requirement from the present three percent to about six percent, or more, by June 30, 1991. This is a sweeping, abrupt mandate. To demonstrate its impact, let me use my own institution as an example.

First, we should note that Landmark's capital of \$80 million exceeds the present requirements set for the industry by \$40 million. We have a better chance than most to meet the government's standards. But, even for us, the government's mandate and timetable would be unrealistic.

3.

If Landmark were required to meet a six percent capital requirement in just two years, it would have one of two choices. First, we would have to try to raise \$24 million in new capital through the equity markets, an amount approximately the total in our two previous efforts when there was no FSLIC crisis.

What would entice future investors to make such an unprecedented purchase of new shares in this present dismal environment?

Our second choice would be to shrink our \$1.9 billions of assets by \$500 million. Of course, if we shrink, our earning power to support tax payments and FSLIC premiums diminishes. Even more disturbing is the prospect of a national fire sale of S&L assets. If the entire industry had to do the same thing at the same time, the price of assets would plummet, necessitating the sale of even more assets, and so on and so forth.

What's more, we must ask ourselves who has the money to buy the assets of America's thrift industry. It certainly isn't Americans. The savings and loan industry could well become another item in the portfolios of European and Japanese investors.

An abrupt enforcement of this capital requirement measure would consign even some healthy thrifts to the financial equivalent of death row. We would just have to sit by and wait for our turn to come.

Does this mean the capital requirement should not be increased? Certainly not. But it must not be done too quickly. It must not be done in such an arbitrary manner. If it is, I can assure the Members of this Committee that they will be sitting here in 1991 with yet another election approaching and an even worse problem to deal with.

I agree totally with the need to increase our capital requirements, but I would advocate a more graduated schedule. If the deadline were extended to June 30, 1993, the nation's healthy thrifts would be far more capable of meeting federal guidelines, being productive, and contributing to the solution rather than to the problem.

The situation we are in is much like that of a driver going along a highway at 55 miles per hour. If he turns a corner and is immediately confronted by a 25-mile-per-hour sign and a pair of patrol cars, he is in real trouble. If he slams on the brakes, he could lose control of his vehicle and crash. That's why it makes far more sense to put up a "Reduce Speed" sign to give the driver time to prepare and to slow down safely. The present proposal does not provide a sufficient warning time. The actions thrifts would have to take to meet unreasonable government standards could well cause a crash in our industry. We want to avoid the crash. All we ask is a little more time.

A similar situation exists with the Bush proposal's requirements for eliminating goodwill. Once again, let me look at Landmark. We have \$70 million in goodwill, which we have scheduled to retire over a 20 year period. That schedule is built into our operations, and it obliges us to devote \$3.5 million a year toward retiring our goodwill. If the retirement deadline is cut in half to just ten years, Landmark's income will be cut roughly in half—not exactly an enticement for the capital markets to make a significant additional investment.

Such a burden would be severe for Landmark, though it probably wouldn't be fatal. Hundreds of other institutions would not be so lucky. A number of middle range thrifts would be wiped out.

Retiring goodwill is sensible in the long run. But forcing thrifts all to do so at a drastically accelerated rate could create a new class of so-called "troubled thrifts" where solvent institutions once stood.

Taken together, the significant rise in insurance premiums, the abrupt doubling of capital requirements and the accelerated elimination of goodwill would create a national crisis for the thrift industry and the American economy. That should be of immediate concern to this Committee.

The mandate of the House Ways and Means Committee is to generate revenue and ease the nation's debt. As constructed, the Bush plan will reduce federal revenues from the thrift industry because of a drastic reduction in its size. It also will increase the nation's debt, and its taxes, as the costs of the plan rise far beyond projections. Not only that, you must take into account the great expense of maintaining a large regulatory machine to administer the industry when the crash comes. It would be far wiser to let the industry have enough time to strengthen itself. Of course, frauds and crooks must be rooted out, but the honest institutions can monitor themselves under reasonable federal guidelines.

4.

Mr. Chairman, Members of the Committee. I think there is no disagreement here over the need to preserve the savings and loan industry in this country. Far too many Americans look to us to provide them the ways and means to buy into the American dream. The mortgages we supply have been and are the financial foundation for millions of this nation's families. On behalf of the honest, well-managed and successful thrift institutions of America, I ask the Members of this Committee to examine the President's proposal with great care. I ask you to consider the fiscal consequences of these proposals and to fashion a prudent solution to our industry's dilemma.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Eshleman
Mr. Pease.

Mr. PEASE. No questions.

Chairman ROSTENKOWSKI. Mr. Gibbons.

Mr. GIBBONS. Mr. Eshleman, you have come closer to my philosophy than anyone that I have heard on that panel.

Mr. Bacon, as much as I respect him as a free lunch fellow, and Mr. Selfe, I appreciate your lecture, but you—and you may save a little money, but you want the taxpayers to pay for it. I guess the taxpayers are going to pay for all of this, and it is a question of how much interest we have to pay until we pay for it.

If the fellow down on the other end of the street would read my lips, I would say no new borrowing. And we could raise the revenue it would take to pay for this and we would save a lot of money by doing that. All we are doing now is just putting off and putting off the inevitable.

And I think I understand. I appreciate you coming. I do not have any questions.

Mr. SELFE. May I make a comment?

Chairman ROSTENKOWSKI. Yes.

Mr. SELFE. I did mean to say in the opening remarks that Mr. Rostenkowski, said, "if you want these tax rules extended, tell us where the money is coming from". All right, I agree. And I suggest this, I suggest that you disallow the deductibility of property taxes on owner-occupied residences. That is worth \$8 billion a year.

I see no reason why a person is entitled to deduct property taxes on his house but he cannot deduct sales taxes, he cannot deduct property taxes on his automobile. There are a lot of other taxes he cannot deduct.

The only reason I suppose that you give the homeowner a deduction for this property tax is to promote home ownership. Well, this is an industry whose principal function is to promote home ownership. Therefore, it is a reasonable request to make of the home owner, give up your deductibility of property taxes. And you will have all the money you need to pay for these merger tax rules.

Chairman ROSTENKOWSKI. Did you ever run for public office, Mr. Selfe?

Mr. SELFE. No, I have not, Mr. Rostenkowski.

Mr. GIBBONS. Let me ask you another one. You are a good, practical business man. What is the average size loan in your institution, residential loan?

Mr. SELFE. Probably \$200,000.

Mr. GIBBONS. That means that they are paying about what, about—

Mr. SELFE. In Alabama the taxes, unfortunately, are very low. I live in a \$200,000 house, and my taxes are about \$2,000 a year. So what I am proposing to you is that I pay \$600 more a year in tax, and I am happy to do it.

Mr. GIBBONS. So you are paying about \$20,000 a year in interest, are you not?

Mr. SELFE. Yes, probably.

I do have—

Mr. GIBBONS. Go ahead.

Mr. SELFE. I do have a comment about interest.

Mr. GIBBONS. All right. Let us hear it.

Mr. SELFE. The second tax proposal, since I am not running for office, is that you make interest on savings accounts tax free, tax exempt. Now, that will encourage people to put their money in savings accounts. That is something this country does not do and should do.

Now, how will you pay for that? You will pay for that by disallowing the interest on home mortgages.

How is that for a political——

Mr. McGRATH. Suicide?

Mr. SELFE [continuing]. Suicide.

Mr. GIBBONS. Well——

Mr. SELFE. I am not on your side of the table, fortunately.

Mr. GIBBONS. Well, you know, the interest on home mortgages is largely enjoyed by just 29 percent of the taxpayers.

Mr. SELFE. I agree that——

Mr. GIBBONS. The other 71 percent or 72 percent do not ever claim any home mortgage interest deductions.

Mr. SELFE. Exactly.

Mr. GIBBONS. So what we have done is we have got the poorest 71 percent of the people subsidizing the upper 21 percent of the people?

Mr. SELFE. I agree entirely.

Mr. GIBBONS. I know Mr. McGrath loves that. That suits Republican philosophy real well. But it does not suit me—it does not make any sense. It is a sacred cow, but it is more of an ox than it is a cow.

So, you know, there are lots of ways around we could raise some money if we just had some of these things. I will show them to you later.

Mr. SELFE. I have made two suggestions here. But I do not see a lot of difference between making interest on savings accounts tax free and reducing the capital gains rate. So, you know, there is some merit in what I think I am saying here.

Chairman ROSTENKOWSKI. Any more questions?

Mr. Pickle?

Mr. PICKLE. Yes, Mr. Chairman.

Mr. Selfe, I thought you were doing pretty good with your testimony——

Mr. SELFE. Thank you.

Mr. PICKLE [continuing]. But in my part of the country I know one of these mergers that has been put together has ended up with a decent profit last year, and some 47 percent of that comes back to the Government. So not all the mergers have been bad. Some are working out. Now, that is just one instance.

But you have gone to meddling when you went into the interest deduction business, and I am going to leave you alone on that issue.

What I would like ask right quickly in my time, Mr. Chairman, is a series of questions of Mr. Stanton. I am going to concentrate on GSEs, the so-called Fannie Maes and Freddie Macs, because I found your testimony very interesting. And I want to read it, and read it again.

I have some questions we put together that I want to ask you. Try and respond to me as quickly as you can in the interest of my time.

As a practical matter, what would happen to the ability of Government-sponsored enterprise, Freddie Mac, Fannie Mae, and so forth, to attract capital if the Federal Government were to say that in the future it would not recognize its moral obligation to guarantee these loans. That is, could they attract capital?

Mr. STANTON. Without the Government guarantee, a number of the enterprises, particularly Fannie Mae and Freddie Mac, are probably significantly undercapitalized and could not do it. There is one enterprise, Sallie Mae, which is very well structured, and it probably could attract substantial amounts of capital even without the guarantee.

Mr. PICKLE. But Freddie Mac and Fannie Mae probably would not, all right.

Mr. STANTON. The problem is it——

Mr. PICKLE. Is it reasonable to say that based entirely on the, quote, almost full faith and credit or the implicit credit as you said, of the Federal Government, that these GSEs are relieved of almost all discipline in the free market normally imposed on those who borrow billions of dollars of capital?

Mr. STANTON. The answer is they have discipline, but not nearly as much as if the Government were not standing behind their obligations.

Mr. PICKLE. All right. Then the GSE does not exercise quite as much discipline, nor does the investor assume that discipline?

Mr. STANTON. The investor is only looking to the implicit guarantee. The investor does not really need to care about the balance sheet of the enterprise.

Mr. PICKLE. All right. Now, I read your testimony. I have not gone over it as carefully as I want to, but I gather that you do not believe that the Federal Government has done an adequate job of replacing that market discipline with some kind of system of reasonable oversight or financial regulations of the GSEs. What additional steps would you say that we ought to take?

Mr. STANTON. Mr. Chairman—Mr. Congressman, if we can do something, that would be to create something like the Comptroller of the Currency to look at all of these enterprises, just looking at safety and soundness, capital requirements, and correcting for the same kind of problems that we saw when we did not regulate the thrifts effectively.

Mr. PICKLE. Well, is there merit to the concept of having a common financial standard for all of these GSEs?

Mr. STANTON. Yes, sir. Because they have common fundamental characteristics, particularly the Federal moral obligation.

Mr. PICKLE. Well, you did suggest, as I understand it, that you would have a single financial regulator for all GSEs. Now, that raises a very interesting question. Since these organizations are much like special purpose national banks, would it be reasonable to put them under the jurisdiction of the Comptroller of the Currency?

Mr. STANTON. That would work. The Comptroller would have the staff, they would have the——

Mr. PICKLE. Well, if you put them under the Currency, that is in effect put them under Treasury I presume?

Mr. STANTON. Yes, sir.

Mr. PICKLE. Treasury controls banks.

Mr. STANTON. Yes, sir.

Mr. PICKLE. Would you then have the banks controlling these GSEs?

Mr. STANTON. That is a hard question. I am not sure of the answer.

Mr. PICKLE. Yes. In other words—

Mr. STANTON. I do not know the extent to which—

Mr. PICKLE [continuing]. It seems to me a conflict of interest there.

Mr. STANTON. The banks in fact could get the Comptroller to be responsive. Some comptrollers have been very responsive to the banks, other comptrollers have really tried to impose careful discipline.

I believe it would be better to separate the two offices within the Treasury.

Mr. PICKLE. All right. But that gets to the—goes to the heart of our problem. If you do this, who is going to really control them? And I do not think we have ever really addressed that question. If we did set up such an off-budget thing, should we have a Government managed loan reserve—a loss reserve like we do in these other institutions?

Mr. STANTON. I believe that would be quite useful. The Government has taken losses. The Government has set aside \$4 billion to take care of Farm Credit System losses, and the implicit guarantee means that future such losses are possible.

Mr. PICKLE. Is it a fact then that the Government assumes most of the down risk on these kind of programs?

Mr. STANTON. Yes, sir.

Mr. PICKLE. Well, is it correct to say then, that because debt issued by the GSE is considerably riskier than Treasury notes, that lenders demand a higher rate of return? I guess that is a fact. And they do get that higher rate of return. And I suppose that this higher rate of return results in billions of dollars in extra interest payments, which the Treasury will have to pay. Is that correct?

Mr. STANTON. Yes, sir.

Mr. PICKLE. Well, is there a limit to the amount of debt that the GSE's can issue?

Mr. STANTON. No, sir. These GSE's are growing dramatically. Sallie Mae has grown by about 18 times in the last 10 years.

Mr. PICKLE. In other words, that debt is increasing in all these GSE's?

Mr. STANTON. Yes, sir.

Mr. PICKLE. Well, then I guess what I am trying to say, Mr. Chairman, is that it looks to me like we have very little regulation on these off-budget enterprises such as Fannie Mae and Sallie Mae and the rest of them. And I do not want to say—and I do not take the position, nor do you as I gather from your testimony—that we ought to do away with them.

Mr. STANTON. Oh, not at all, sir.

Mr. PICKLE. But we are asking to create another one with little control over it where we have got to pay the interest as well as the principal later on, and that we—

Mr. STANTON. Yes, sir.

Mr. PICKLE [continuing]. Are being asked to pay \$50 billion. I guess this Congress is going to be very hesitant to underwrite \$50 or maybe \$70 billion—we do not know how much we are going to go into it—as another off-budget item. I think it has to be one of the considerations. We are going to be solving our problems, but it may be costing us more than if we went out and we borrowed directly and paid it.

Mr. STANTON. Yes, sir.

Mr. PICKLE. Either choice is a tough one, and it is going to be very difficult. But I think the Congress must start looking at of these Government-sponsored enterprises because they are getting bigger and bigger. In this case we do not have just an implicit promise, we have got an explicit one in effect. Implicit I guess from the interest, explicit as far as the principal is concerned. We have not looked at it, we have brushed it off. I know some members of the committee have been worrying about this for a long time. And now we are expanding this approach. I do not want to condemn the administration for trying to come up with an answer of some kind. I want to conclude by saying I have the feeling that we probably ought to renew these tax incentives for a period of time because whatever happens, this thing is not going to be settled overnight. And if we are left in limbo for 6 months or a year, many of the sound institutions are going to go under. And if the banks come in, the FDIC, and dumps seized property, I am telling you, you will bust Texas wide open and pour it down the Gulf of Mexico.

Nobody wants that. But I think we must guard against that. And we are fighting time. So we may have to consider some kind of extension.

Now, Mr. Selfe, I do not think you have done too good a job—nor did we do a good job—because I think you blew smoke at us, and we accepted it, for years, and now we are all having to pay for it. But that is another question. So I just am saying that this Congress ought to take a very close look at all of these GSE's and how we control them and who controls them if we do it.

So I thank you, Mr. Chairman.

Mr. GIBBONS [presiding]. Any further questions?

Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

Mr. Stanton, I think you raise a troubling point. And I know Mr. Pickle was expressing some alarm that I am sure many of us share. And without meaning to—just working off your testimony, without meaning to suggest in any way that there is anything remiss with the National Credit Union Administration or Freddie Mac or Fannie Mae, or any of those, the fact is that there could be something.

Because I think if we were sitting here 4 years ago, 5 years ago, we would have said—if anybody suggested that the FSLIC would have trouble meeting their obligations, we would have said that is preposterous. Do you not agree? I mean there was a time not so long ago, and I do not think any of the panel would say it was not

so long ago that the idea of one of our guarantee insurance institutions for depositors having a financial trouble, you would have dismissed that as absolutely impossible.

Well, let us try just for a minute, and let us deal with Sallie Mae, which you talked about.

Now I do not know who—who appoints—does the President appoint people to Sallie Mae? There must be a board there somewhere?

Mr. STANTON. Yes, sir. Sallie Mae is structured to have a board that is shareholder elected. And——

Mr. STARK. And the shareholders are the lenders?

Mr. STANTON. One third lenders, one third schools, and one third publicly appointed members by the President.

Mr. STARK. So it is a self-regulating group so to speak?

Mr. STANTON. Yes, sir.

Mr. STARK. Now, I do not know what the bankers on the panel would say, but as I recall from my limited experience there probably is not 1 in 100 Sallie Mae student loans that a standard financial institution would make today without Government insurance? Is that—maybe it is two in a hundred. But it is my understanding that as collateral a student loan is not worth much.

Mr. STANTON. Well, Sallie Mae may be different in that regard from some of the other enterprises because it deals largely in guaranteed student loans.

Mr. STARK. That is what I am saying. But without the Federal guarantee——

Mr. STANTON. That is right, sir.

Mr. STARK. There is nobody in their right mind that would make those student loans, is there, in a traditional—I mean except as an eleemosynary gesture, the guarantee is what makes those loans negotiable and makes them considered investment grade. Is that not——

Mr. STANTON. Yes, sir.

Mr. STARK. That is a fair statement I think.

So basically what you have is a Federal guarantee that is the basis for all of this paper being generated, admittedly for a good cause, and I think what you are telling me is that the only people who review all of this paper—and you tell me now that there is \$26 billion of it. It is growing at what rate?

Mr. STANTON. It is growing—its target growth is approximately 20 percent a year. And it has grown by about 18 times since 1979.

Mr. STARK. I really knew that, because I am not so smart that I can tell you this number in my head. Which means that in 1994 we are going to have \$65 billion guaranteed abroad in the land held by these same banks——

Mr. PICKLE. By when?

Mr. STARK. By 1994, \$65 billion if they keep growing at 20 percent. Now, they may not. The baby boom may limit.

But what I am trying to say is we—that is added in really to the deficit, as many of us would consider it, yet it is not counted. It is not counted for Gramm-Rudman, it is not counted when we go for our debt limit bills each year. We do not take it into effect. This is just a small part of it. And further, I do not think anybody audits it. Nobody reports to us, that I know of, and puts the good house-

keeping seal of approval on the adequacy of the reserves that Sallie Mae may or may not have. Is that not correct?

Mr. STANTON. That is absolutely right. Sallie Mae has no financial regulator at all.

Mr. STARK. And so I guess the picture I am painting is that the fox—may be watching the chicken coop—without suggesting for a minute that schools obviously want to see the volume of Sallie Mae because they are all strapped, and the costs are going up, and they do not have enough scholarship funds, and it is an admirable public policy. I think all of us agree with that.

Mr. PICKLE. Will you yield?

Mr. STARK. Sure.

Mr. PICKLE. I would ask you, Mr. Stark, as a former banker, I would ask this panel, we are talking about this debt that is growing. Is it not debt increasing? And as a matter of fact, is not the debt effectively competing with Treasury's debt?

Mr. STANTON. Oh, absolutely. And because of the—

Mr. PICKLE. And driving up the direct costs of Federal borrowing?

Mr. STANTON. Yes, sir.

Mr. STARK. And again, for the best cause many of us can think of. But my point is the schools want it, so they are a third of the board. The banks want it because, quite frankly, they do not have to use profits to make charitable contributions to do the right thing. They can make the loan—which we all want to do. I mean it is the most touching thing, a kid who has worked hard to get through high school, wants to go on to college, does not have the resources, to say here is the loan, knowing that if a kid does not pay it back—and we are always a little skeptical about that, even with our own kids—Uncle Sam will make us whole, a banker's dream. And the rates are not bad.

So you have a third—the other third of this group are the bankers who—and actually servicing these things is probably a fairly profitable enterprise for some of these institutions that may package them and sell them. And the other third are public interest people whose interest is in seeing the thing going.

What I am trying to point out is that there is a chance in that circle for people to get careless, for unscrupulous operators to perhaps come in and find something else to fund, or to generate more activity for the fees that are involved in selling these securities. I can dream up a lot of horror stories. And nobody is minding the store, as I understand your testimony—is that not correct—in the sense that this thing could go—it is at \$26 billion, and I think most of us would be surprised at that, it could go if not \$65 billion, could be \$50 billion, or in 5 or 7 years instead of 4.

All that debt increases the effect of our deficit, even if you want to argue that it is not really deficit. I think it is. And we get not an audit and we do not actually have any limits on the upside that I am familiar with. Is that correct?

Mr. STANTON. Yes, sir. I would add one thing about Sallie Mae. Moral hazard is not something that everybody needs to succumb to. And Sallie Mae has shown itself to be relatively risk-averse. The Department of Education oversees the Guaranteed Student Loan

program as a whole, whether those loans are held by Sallie Mae or by banks or——

Mr. STARK. So does the Federal Home Loan Bank Board oversee the savings and loans, and bright, tough examiners. They may not have ever anticipated the State of California's regulation as being as lax as it turned out to be. But fault is a useless concept. I really do not care whose fault it is or was but only that we are in the soup we are in.

The point is that we are there, and if anybody should have egg on their face, I suppose it is this committee for not having said who is looking? I mean you just kind of assume that things are going along well. And what I am hearing from your testimony is not necessarily that things are not going along well, but if they were not we would not know.

Mr. STANTON. Yes, sir. That is right.

Mr. STARK. Is that correct?

Mr. STANTON. Until it was too late.

Mr. STARK. So it is not legislation that is necessary to tighten regulation. I do not think you are suggesting that, are you? And you are not suggesting that we limit the amount that any of these people——

Mr. STANTON. No, sir.

Mr. STARK. But I think you are suggesting that we ought to be better informed and perhaps ought to have some kind of audit procedure so that we are aware prospectively of problems if they develop in any one of these off-budget agencies. Is that what you are telling us?

Mr. STANTON. The bottom line is that I believe that Government sponsored enterprises can be considered as special kinds of national banks. In the same way that Government uses examiners to validate the quality of management systems and credit quality and lending policies, the Federal Government should oversee safety and soundness of these institutions. A good first step would be for the Federal Government to insist on accurate, solid reporting requirements so we have early warning if a problem is developing.

Mr. STARK. Let us assume that you and I can get 219 members of Congress and 51 Senators and the President to agree with us and put this all into a law. And I would ask the entire panel. Would you be willing to see us increase the national debt limit in effect to allow direct borrowing from the Treasury for all of these functions and thereby keep some more control so that we then decided what we are going to give to Sallie Mae and Fannie Mae and Freddie Mac, and would that be——

Mr. ESHLEMAN. Absolutely yes.

Mr. STARK. Well——

Mr. STANTON. Congressman, I will let him take the yes position. I would have to say that there is a problem there.

Mr. STARK. OK.

Mr. STANTON. Like national banks, these are privately run institutions, with one exception we do not need to go into. And therefore to put them into the Government would be to give them a competitive advantage——

Mr. STARK. But they are into the Government to the extent of the guarantee. And we hope that they never have to get messed up

with us and call that guarantee. But a guarantee is a guarantee. And that is our—it would seem to me, therefore, we are in a good position to at least negotiate with these privately owned entities to say maybe we ought to take some more and coordinate the sale of your debt so that it conforms with national policy, whatever that may be.

And that is one—but then that is the alternative, where we go to raise the debt limit, that is a great political argument. And I mean, what you are suggesting—Mr. Eshleman I think is inferring that he concurs—you are saying we may create our own problems. I am not suggesting we run it, or that the Government runs it. I am just saying that we have some kind of responsible audit that could anticipate problems before they come up.

Had we had that, we might have been tougher on savings and loan regulations some years back. I do know if we would have or not. But it is an area that we can look at and say, OK, whatever happened in the past was not done to the best advantage of the country, judging from where we are now. How can we see that this does not happen again. And I gather, Mr. Stanton, you are saying there are other institutions up, I do not think it is going to happen again in the savings and loan industry. I think we swallowed this pill and maybe—in 1931 and 1989, so maybe every 50-odd years we have to go back and take a bath and start all over.

But let us—I think what you are suggesting, and I think your testimony is so relevant, that we can watch out and prevent this from happening with a little bit of oversight. And I appreciate that. I am sorry, I just was particularly intrigued by this and concerned.

If any of the others would like to comment on this issue——

Mr. ESHLEMAN. I would like to make just two——

Mr. STARK. Please.

Mr. ESHLEMAN [continuing]. Comments, two very quick comments.

One, my view is that the national debt is the sum of things that Congress calls the national debt plus all of these off-budget agencies, plus \$100 billion or so for the FSLIC crisis. That money is already gone. In order to be gone, it has to become a national debt, and it is already in that.

I would like to add just a P.S. to some comments Mr. Pickle made. He pointed out that these independent agencies compete with the Treasury for capital funds. From my perspective, it is worse than that because they not only compete with the national Treasury, but they end up driving up interest costs for every savings and loan and bank in the country. So this competition for funds is part of the problem.

Mr. STARK [presiding]. I, as I say as just a casual reader of the newspapers every day, anybody who thinks that what is going on now is not driving up the cost of deposits is not reading the ads from many of your institutions, begging for money. And I just watch those rates go up every day and think how high is high?

I want to thank the panel very much—Mr. Coyne, did you want to inquire?

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Eshleman, as you know, in December there was somewhere in the neighborhood of \$8 billion withdrawn from savings and

loans. If this problem were to continue, what effect would it have on President Bush's proposal for the savings and loan industry?

Mr. ESHLEMAN. Well, there is no question that the two are incompatible. There is no question there is a silent run going on throughout the thrift industry certainly. I think it may have some spill over into commercial banks as well. The two are just totally incompatible.

My plea is to somewhat resolve this thing quickly. I have said for the record previously any solution, even if it is a flawed or bad solution, a quick solution is better than procrastination on this issue.

Mr. COYNE. Thank you.

Mr. Stanton, over the past several years we have pretty much listened to what the savings and loan industry has had to say relative to remedies to the problem. And that has not been adequate. And I guess many of us are wondering today whether we should be taking seriously the advice that we get from representative, some representatives, of the savings and loan industry.

Do you care to comment on that?

Mr. STANTON. I guess to my mind there is at this point a substantial body of disinterested wisdom on effective regulation of safety and soundness of institutions. The fundamental principle is that when the Government lends its guarantee to somebody for insuring deposits, through implicitly guaranteeing enterprise obligations, the Government better police the use of the guarantee. It would be just as if you lent your personal guarantee on a note and then did not pay attention what they did with your credit.

And the Government must police the use of that guarantee. And the way you must do that is through effective regulation. Given that substantial body of knowledge, we can then go and debate over in which institutions should the regulator be located in order to keep maximum independence and maximum dedication to protecting Uncle Sam from taking another hit.

Similarly, on some of the other issues, it is a simple, technical fact that if you fund the bailout of FSLIC through an off-budget, Government-sponsored enterprise, we will spend a few billion dollars more to do it. We do not need an enterprise in order to go off budget. We can go off budget the way the Federal Financing Bank was placed off-budget for a while on the way the Congress decided simply through law to put the Export-Import Bank on and off budget several different times.

That is a separate decision. But it is a simple, technical fact that you do not need REFCO, a Government-sponsored enterprise, to accomplish that fact. So I believe the Congress could be guided substantially because over the past several years we have seen a tremendous buildup in really high quality analysis of these problems.

Mr. COYNE. Thank you.

Mr. ESHLEMAN. Mr. Coyne, I might just add that as the committee has observed, the longer time you spread out these costs, you are going to pay interest on that. And somebody talked about the compounding of interest. The longer this cost is funded over, the much more expensive it will become for the Congress.

Mr. COYNE. Thank you.

Mr. STARK. I want to thank the panel very much and appreciate their participating and their very useful testimony.

Our next panel consists of representatives from the Consumer Federation of America and Consumers Union, Ms. Peggy Miller who is a legislative representative, and Michelle Meier, the counsel for Government affairs of the Consumers Union, and Ms. Miller representing Consumer Federation of America. The Association of Community Organizations for Reform Now, affectionately known by one and all as ACORN, is represented by Irma Pernell, the president, and Mr. Christopher Paterson of Rockville, Maryland, who is freelancing.

The panel is welcome to the committee. And for those of you who have submitted prepared testimony, it will appear in the record in its entirety without objection. That is easy. And you may proceed to enlighten me or expand on your testimony or paraphrase it in any way you are comfortable.

We will hear first from Ms. Miller.

STATEMENT OF PEGGY MILLER, LEGISLATIVE REPRESENTATIVE, ACCOMPANIED BY MARK N. COOPER, RESEARCH DIRECTOR, CONSUMER FEDERATION OF AMERICA

Ms. MILLER. Thank you. It is a pleasure to be here today.

I am Peggy Miller. I am here on behalf of the Consumer Federation of America. With me is Dr. Mark Cooper, our Research Director.

CFA is an organization that represents 240 organizations around the country who represent around 50 million Americans. This is not usually a committee that we come before. In fact, most of my time is spent over in the Banking Committee. I am not exactly pleased to be here today talking about this, and you are probably not exactly pleased to be trying to figure out what to do to raise the money for this S&L \$100 billion debt.

But we came here because when this whole thing ballooned our members, probably more actively expressive than they ever have been before on banking issues, were scared. The public confidence had been lost. They were calling, they were worried. They were asking us to try to analyze the situation, not only from the standpoint of safety and soundness and from the standpoint of service, but who was going to pay.

So we conducted an analysis, and I will not go into the specifics. Mr. Cooper will cover those. I just want to hit a couple of points before I turn it over to him.

Basically what we have been trying to say for a number of years in terms of the banking situation is that fees have increased on low and moderate income people because of deregulation. One of our greatest concerns as soon as the Bush plan hit the press and was presented to the Congress was of the insurance fee increases. And what our statistics show today is basically if that is allowed to stand as part of the bailout fund, it will be borne by low and moderate income. And we intend to prove that to you today.

In addition, we carry that analysis further, what would be the most equitable and the most economical approach? We do not want to pay for this. None of us want to pay for this. But we all have to face the fact that we have got to pay for this. So in line with that approach, what is the fairest and what is the lowest cost way to do

it? And that is why we are here, because the only thing we came up with through our analysis was taxes.

And looking at that, the only thing we want to also point out is that from a tax approach, because—and I remind the members that because of the banking situation, because this is a bailout, taxes for the FSLIC situation, we have to take an unusual stand again, and that is that it seems absolutely unjustifiable to take the money at all from the low and moderate income. And that is because they have had a net cost in banking services. Throughout all of this problem, throughout all the disarray and everything you have been hearing about in terms of deregulations and the impacts over the last few years, the low and moderate income have been paying. While everyone else has been getting high interest rates, they have been paying.

So we had to conclude that taxes on upper income was really the only way that was an acceptable approach. The only other thing that we come before this committee to also talk about, we are going to be, of course—we are continuing to work with the banking committees in terms of regulatory reforms, safety and soundness reforms, early intervention. We have concerns on those points. We have deep concerns about high risk, and we will be testifying before them and trying to work at those avenues.

And we have come to the conclusion that regardless of those concerns which we will be trying to amend and work with the committees on, we also are extremely concerned that the housing function of the savings and loan is paramount. It is important, it is critical, it should be maintained.

In addition to that approach, the trouble over the last few years is that the housing function is no longer sensitive to the different housing needs in this country. The low and moderate income again are facing a situation where they are not getting loans, where the loan arrangements do not reflect the sensitivities necessary. Various types of limited equity, and types of mutual ownership arrangements, must be put into the housing code.

We are going to be working on a cash advance system where you use the cash advances that are available to the savings and loans to try to tie those directly to specific programs that are targeted to low and moderate income and to first-time home buyers. But we ended up with one problem. And that problem is why we are also here today in a very serious manner.

The one problem is you still have the low income subsidy. If we ask the saving and loans to move money towards the low incomes, you still have to provide a direct subsidy of a few percent to make those realistic loan packages.

In that event, we are here on a fairly unpopular note, to basically ask the committee that the mortgage interest deduction—Consumers Union will be going into this more thoroughly. We just wanted to support what they will be saying in terms of taking a look, asking the committee to help us in this regard of redirecting the savings and loan into their housing function, redirecting them so that they can have some subsidization of the low incomes through a taking a look at the mortgage interest deduction and the lowering of that deduction and possibly the closing out of the second home allowance under the home equity loan.

CBO projects that there can be \$10 to \$12 billion raised through this. That could help to subsidize the cash advance system that we are also developing.

These are two very serious proposals. We would like to work with the committee in this regard. But we think that programs of this nature plus a tax approach really aimed at the upper income are the only realistic ways that we can deal with these problems.

Thank you.

[The statement of Ms. Miller follows:]



Consumer Federation of America

TESTIMONY OF
PEGGY MILLER,
LEGISLATIVE REPRESENTATIVE

AND

DR. MARK N. COOPER,
RESEARCH DIRECTOR,
CONSUMER FEDERATION OF AMERICA

BEFORE THE
WAYS AND MEANS COMMITTEE,
UNITED STATES HOUSE OF REPRESENTATIVES

ON

THE SAVINGS AND LOAN CRISIS

MARCH 9, 1989

Mr. Chairman and Members of the Committee,

My name is Peggy Miller. I am a Legislative Representative at the Consumer Federation of America (CFA). I am accompanied by Dr. Mark Cooper, CFA's Research Director.

Founded in 1968, the Consumer Federation is composed of over 240 state and local organizations representing more than 50 million consumers. The Federation's purpose is to represent consumer interests before the Congress and Federal agencies.

We appreciate the opportunity to present our views to you on what is obviously a monumental consumer issue.

**AN EFFECTIVE AND EQUITABLE SOLUTION TO THE S&L CRISIS
REQUIRES ACTION OF THE WAYS AND MEANS COMMITTEE**

In recent years CFA has concentrated its banking efforts on improving consumer services and information. That can no longer be the case. So much is at stake in the S&L crisis that we feel compelled to take a position on the issue. We believe that the action of this Committee is required if an effective and equitable solution to the immediate crisis is to be found.

The Administration has proposed to spread the bailout over decades. This multiplies the cost dramatically by piling interest on top of injury. The Banking Committee points out that this funding approach could triple the cost of the bailout.

The only way to avoid the insult of an additional \$100 to \$200 billion of interest is for this Committee to fund the bailout in the near term through taxes. The Banking Committee has arrived at this conclusion and we support its judgment.

The central focus of our remarks today is on another equally good reason for the Committee to enter the bailout fray. Not only does an income tax-based approach appear to be more economical in solving the problem, it will also be more equitable. We are releasing to the Committee today the results of an analysis we have done of who pays for the bailout under alternative approaches to raising funds.

**LOW AND LOWER MIDDLE INCOME HOUSEHOLDS WILL BEAR AN
UNFAIR BURDEN, IF INSURANCE PREMIUMS ARE INCREASED**

The answer to the question of who bears the burden is quite clear. Whatever funds are raised by increases in insurance premiums are almost certain to fall most heavily on lower and middle income households. Figure 1, taken from our study, demonstrates this point.

If the Committee raises the funds through income taxes, the poorest fifty percent of the population (with incomes below approximately \$25,000 in 1987), which earns only 17 percent of income, will bear about 6 percent of the burden and the poorest would pay the least. This is a result of the progressivity of our income tax code.

In contrast, if publicly-insured financial institutions, who have engaged in extensive price discrimination in setting fees and interest rates by establishing liquidity conditions on accounts, are allowed to allocate the costs, which would happen under a premium-based approach, then the poorest fifty percent of the population will bear 36 percent of the burden.

In our analysis, we utilize the incidence of checking fees to depict how costs have been shifted onto lower and middle income households in the era of deregulated banking. This is the way we believe cost increases for financial institutions will be passed through in the future as well.

As a result of conditions placed on accounts by financial institutions, lower income households are more likely to be forced to pay fees on their accounts and/or pay higher fees per transaction and/or earn lower interest rates. The conditions that have been placed on accounts require minimum balances or loss of liquidity. These pose a greater barrier to lower income households who lack assets and need liquidity.

These are the households who are least able bear the burden of the bailout. These are also the households who have been victimized most by the S&L turmoil of recent years.

Because they do not have sufficient assets, low and moderate income households were not only unable to cash in on the high interest rates offered by thrifts during the years of high stakes financial gambling, but also to avoid the heavy fees imposed on services. Because both public and private bankers lost sight of the fundamental purposes of publicly insured funds for financial institutions, these households lost access to capital for their basic housing and business needs.

To allow these households to be victimized again, by allowing financial institutions to shift the burden of the bailout to those consumers with the fewest options and the greatest need for liquidity, would be an unacceptable miscarriage of justice.

The middle class is also better off with a tax-based approach. If financial institutions are left to do what they have with checking fees, about a quarter of the burden falling on households with incomes between approximately \$25,000 and \$37,500 in 1987. Under a tax-based approach, even assuming the current incidence of taxes, less than one-seventh would fall on these households.

A TAX-BASED APPROACH TO FUNDING THE BAILOUT WILL PREVENT DISCRIMINATION AGAINST LOW AND MIDDLE INCOME HOUSEHOLDS AND MINIMIZE DISRUPTION IN THE FLOW OF FUNDS

Our report also points out that assertions that financial institutions will absorb some of the burden provide little solace to lower and middle income households. Efforts to force savings and loans to absorb part of the burden are much more likely to help the rich than the poor or middle class.

The stronger the competitive pressures on the savings and loans not to pass-through any cost increases, the stronger also will be the pressures to direct increases to lower and middle income households. The first response of financial institutions to imposition of increased costs will be to avoid raising fees or lowering interest rates on those accounts which are the most sensitive to price changes. Larger asset holders, who have greater flexibility, will be the first group shielded from the cost pass-through.

The data indicates that in order for these groups to prefer an increase in premiums to increases in income taxes, savings and loans (and banks) would have to absorb three-quarters to nine-tenths of the costs. That simply will not happen.

Similarly, by going outside the industry for funding, the size of any direct cost increase will be reduced. This would help to diminish the inclination of financial institutions to price discriminate in passing the burden through to specific instruments.

By this line of reasoning, one clearly arrives at taxes as the logical conclusion. They provide a relatively progressive, broad-based approach to funding. They deny the financial institutions the ability and reduce the incentive to price discriminate in allocating the burden of the bailout.

THE BAILOUT SHOULD NOT DEGENERATE INTO AN INCREASE IN THE DEFICIT AND IT CAN BE AS PROGRESSIVE AS THE CONGRESS DEEMS FIT

Two critical provisos should be added. First, when we say taxes, we mean taxes. The bailout cannot be allowed to degenerate into an increase in the deficit. The burden of deficit reduction is never the same as the burden of taxes. Program cuts, precipitated by deficit reduction, could well fall on the wrong people. Therefore, the funds must be raised explicitly for these purposes, or else it could degenerate into an even more regressive approach.

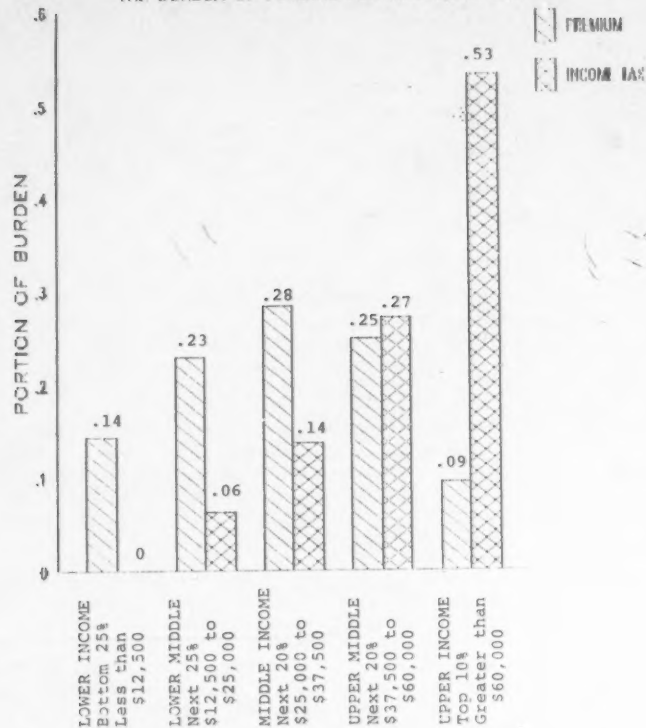
Second, our comparisons have been made only with the tax burden as it currently stands. Analytically, this is the equivalent of an across the board surtax. Legislatively, the Committee has the capacity to target the incidence of the tax as it sees fit. Our argument that upper income groups profited and lower income groups lost out in the financial turmoil of recent years suggests that upper income groups is where the burden should fall.

IMMEDIATE ACTION IS NECESSARY TO PRESERVE AFFORDABLE SERVICE FOR LOW AND MIDDLE INCOME HOUSEHOLDS

CFA has fought for years to have legislation passed which makes low cost checking available and insulates low and moderate income households from the burden of the rapid growth in fees and minimum balance requirements stimulated by deregulation. Many people are already unable to afford to use the nations financial system and many institutions refuse to offer basic banking services at affordable rates. If premiums are raised to fund the bailout, these cost increases will be passed on primarily to the very customers who are already struggling to remain within the banking system. The tragedy of the S&L crisis would be compounded by falling most heavily on those least able to bear the weight.

Thank you Mr. Chairman and Members of the Committee. We appreciate the opportunity to share our views with you today and we look forward to working with you to solve the pressing consumer problem.

THE BURDEN OF FINING FOR THE S&L RAIL OUT



SOURCES:

From Bailing Out the Savings and Loans: Who Bears the Burden Under Alternative Financing Approaches (Consumer Federation of America, Washington, D.C., March 9, 1989)

The incidence of fees is estimated from U. S. General Accounting Office, Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation, July 1987, Tables 3.1 and 3.2 are used to estimate fees paid per account. The proportion of the population holding accounts is taken from R. B. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, Table 12. The latter established the size of the segments.

The incidence of taxes is based on Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987, Table B-1, for 1988 taxes. The third decile is split one-third for low income and two-thirds for lower middle income.

Dollar Income amounts are from U.S. Department of Commerce, Bureau of Labor Statistics, Current Population Survey: 1987 Income, computer print-out.

ADDENDUM: TESTIMONY BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
BY PEGGY MILLER, CONSUMER FEDERATION OF AMERICA
MARCH 9, 1989

Furthermore, the Consumer Federation of America would like to join Consumers Union today in support of its request that the Committee assist in the need to raise subsidy funds for low income housing loans to be offered through the Savings and Loan industry through such mechanisms as lowering the mortgage interest deduction and phasing out the tax deduction of second homes under the home equity loan deduction.

The Savings and Loan industry was established for a primary function: to provide home mortgage loans. In the last eight years, many of the thrifts have moved away from this lending function, some to such a degree that they have brought us here today, as we try to figure out a way to pay for their unwise, high risk investments. We strongly support the continuation of this function.

Even though we support the return to this important function, we believe that the function must be redefined to meet current needs. Those who are low income need loan officers sensitive to their housing needs who can work with individuals and communities in the fashioning of multi-unit, limited equity and mutual ownership arrangements, as well as in the provision of single-family units. Those who are first time home buyers need the lowest interest rates and the lowest down payment requirements possible, as well as helpful loan officers who understand their needs.

The cash advance program within the Savings and Loan system provides thrifts with funds at lower interest rates. These funds currently are not tied to any particular purpose. If such funds were passed through to first time home buyers and to low income housing customers, they would help address the needs of these people for housing loans at reasonable terms. Still, an additional subsidy is needed to address the need for even lower interest rates on low income loans.

This Committee could help to pay for that subsidy by lowering the mortgage interest deduction and wrapping in the second home deduction under the \$100,000 ceiling of the home equity loan deduction. Based on CBO figures, if the Committee were to lower the mortgage interest deductions to \$12,000 for single returns and \$20,000 for joint returns, approximately \$10 billion dollars over the next five years could be raised. An additional \$2 billion could be raised through the elimination of the second home deduction on home equity loans according to CBO. Such sums, if attached to the cash advance program, would provide much relief to those in greatest need for a home.

This is not the only way to raise funds for low income housing needs, we realize. There are other approaches being presented, including the concept of raising funds throughout the financial sector by placing a small fee on all financial transactions.

We recommend that the Committee take a serious look at all such ideas presented to you, and assist us in this task of addressing the housing needs in this country through a safe, sound thrift system. It would be unfortunate if we all have to pay for over \$100 billion in mistaken lending practices without insuring that the institution causing such costs did not serve a true public function in the future.



Consumer Federation of America

BAILING OUT THE SAVINGS AND LOANS
WHO BEARS THE BURDEN UNDER ALTERNATIVE FINANCING APPROACHES

MARCH 9, 1989

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121



CONTENTS

I. INTRODUCTION.....	1
A. BACKGROUND AND RESEARCH ISSUE	
B. SUMMARY AND OVERVIEW OF RESULTS	
II. METHODOLOGY.....	2
A. INCOME GROUPS	
B. UNDERSTANDING THE INCIDENCE OF FEES	
C. INCOME AND THE INCIDENCE OF INCOME TAXES	
D. CONSIDERING OTHER FINANCIAL ASSETS	
III. RESULTS.....	9
A. THE INCIDENCE OF ALTERNATIVE FUNDING MECHANISMS	
B. THE ABSORPTION ARGUMENT	
C. SENSITIVITY OF THE INCIDENCE ANALYSIS TO INCLUSION OF SPECIFIC TYPES OF ASSETS IN THE FUNDING BASE	
IV. POLICY DISCUSSION.....	13
FOOTNOTES.....	16

LIST OF TABLES

1. DEFINITION OF INCOME GROUP SEGMENTS.....	3
2. CHECKING ACCOUNT DATA.....	5
3. ALTERNATIVE FORMULATIONS OF THE COST SHIFTING ARGUMENT BASED ON CHECKING ACCOUNT FEES.....	7
4. ESTIMATED DISTRIBUTION OF FAMILY INCOME AND FEDERAL TAXES, 1988.....	8
5. PROPORTION OF BURDEN BORNE BY VARIOUS GROUPS.....	10
6. ALL LIQUID AND FINANCIAL ASSETS COMPARED TO FEES AND INCOME TAXES.....	12
7. THE DISTRIBUTION OF FINANCIAL ASSETS.....	14

I. INTRODUCTION

A. BACKGROUND AND RESEARCH ISSUE

It has now become apparent that the American public is going to pay a heavy price for the failure of hundreds of savings and loans and to restore the industry to solvency. The question of which Americans will pay the most has moved to center stage.

This paper examines the burden that alternative approaches to raising the funds would place on households at various income levels.¹ The central question for this analysis is

Of every dollar raised by each approach, what percentage would be paid by the following groups -- low income, lower middle income, middle income, upper middle income, and upper income?

We analyze two primary options for funding the bail-out -- increases in premiums passed through to holders of assets and revenues raised from personal income taxes. Under the first approach, we assume that financial institutions will pass cost increases through to consumers in the same manner as they have imposed checking account fees on them. Under the second approach, we assume that the burden will fall in the same manner as the current income tax burden falls.

We also consider the distributional impact of the possibility that financial institutions will be unable to pass-through all the increases in insurance premiums. We ask how much of the burden would have to be absorbed by financial institutions for various income groups to be indifferent between the premium-based approach and the income tax-based approach.

Finally, we present evidence on direct levies on various financial instruments. These are considered less likely, since they would require explicit administrative mechanisms to directly collect new taxes or fees.

B. SUMMARY AND OVERVIEW OF RESULTS

The analysis shows that because the tax code is progressive, the poorest fifty percent of the American people, who earn only about 18 percent of annual income, would bear about 6 percent of the burden if income taxes are used to fund the bailout. They could bear about 37 percent of the burden, if financial institutions pass the costs through to lower and middle income households as they have in the past. This is five times as much as they would pay under an income tax-based approach.

In contrast, the wealthiest ten percent of the population, who earn about 36 percent of income, would pay less than ten percent of a premium increase, if lower and middle income households are targeted for fee increases as they have in the past. This is about one-sixth as much as they would if taxes are used to raise the funds.

The data indicates that efforts to force savings and loans and/or banks to absorb part of the burden are much more likely to help the rich than the poor or middle class. The stronger the competitive pressures on the savings and loans and banks to not pass-through any cost increase, the stronger also will be the

pressures to direct increases to lower and middle income households. Competition for funds will lead institutions to shield their large asset holders, who have greater flexibility from cost increases. In order for lower and middle income groups to prefer an increase in premiums to an income tax-based approach, savings and loans and banks would have to absorb three-quarters to nine-tenths of the costs.

The report argues that spreading the burden of the bailout with taxes makes sense not only for simple distributional reasons, but also for broader reasons of equity and efficiency. Because lower income groups hold smaller accounts and are more likely to need liquid assets, they were the least likely to profit from the higher interest rates brought on by the frantic efforts of floundering savings and loans to attract deposits. Similarly, broadening the financing base diminishes the chance that funds will move from one type of institution or one category of assets to another to avoid the burden of the bailout. This dampens the inclination of financial institutions to price discriminate against lower income households in passing the burden through.

II. METHODOLOGY

A. INCOME GROUPS

Because of the melding of three data sets, we define the income groups as follows for the purposes of this analysis (see Table 1).

Lower income households are those in the bottom quarter of the income distribution. This is roughly equivalent to those households with incomes below \$12,500 in 1987.

Lower middle income households are the next quarter of the income distribution. Their incomes were between \$12,500 and \$25,000 in 1987.

Middle income households are those in the third fifth of the income distribution. Their incomes were between \$25,000 and \$37,500 in 1987.

Upper middle income households are the next fifth of the .pn 5 income distribution. Their incomes were between \$37,500 and \$60,000 in 1987.

Upper income households are the top ten percent, with incomes above approximately \$60,000 in 1987.

B. UNDERSTANDING THE INCIDENCE OF FEES

In order to estimate the likely impact on each population segment an increase in fees, we have combined a detailed, 1983 analysis of household assets conducted by the Federal Reserve Board (FRB) with a recent General Accounting Office (GAO) study on the incidence of checking account fees.²

These studies are somewhat dated, but they are the most recent government studies available and we have constructed the analysis so that the result will not be affected by recent changes in the distribution of assets or fees. In fact, our approach underestimates the regressive nature of fees.

TABLE 1:

DEFINITION OF INCOME GROUP SEGMENTS

GROUP INCOME				
		^a HOUSEHOLD INCOME 1983 FINANCIAL	^b ADJUSTED GROSS 1986 TAX	^c HOUSEHOLD INCOME 1987 CPS
LOWER	BOTTOM 25 %	Less than 10K	Less than 8K	Less than \$12.5
LOWER MIDDLE	NEXT 25 %	10 to 20	8 to 19	12.5 to 25
MIDDLE	3rd FIFTH	20 to 30	19 to 30	25 to 37.5
UPPER MIDDLE	4th FIFTH	30 to 50	30 to 50	37.5 to 60
UPPER	TOP 10%	50 or more	50 or more	60 or more

SOURCES AND NOTES:

a) R. S. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, Table 12. The percentages are driven by the groupings of households contained in this data set. Other data sets are then fit to the 1983 percentages.

b) Martha Shelly and Robert Kallish, "Individual Income Tax Return, Preliminary 1986 Data," SOI Bulletin, Winter 1987-88, Table 1.

c) U.S. Department of Commerce, Bureau of Labor Statistics, Current Population Survey: 1987 Income, computer print-out.

First, although the magnitude of assets held by households has increased in recent years, we have defined the population segments in such a way that the holdings of each segment relative to the others has probably not changed a great deal. Most accounts suggest that the distributions of assets may actually have become more skewed toward the wealthy. Therefore, our incidence analysis will likely underestimate the impact on lower and middle income groups.^{3/}

Second, we have conservatively estimated the incidence of fees based on the checking account data. As a result of conditions placed on accounts by financial institutions, lower income households are more likely to be forced to pay fees on their accounts and/or pay higher fees per transaction and/or earn lower interest rates. The conditions that have been placed on accounts require minimum balances or loss of liquidity. These pose a greater barrier to lower income households who lack assets and need liquidity.^{4/}

In order to suggest the potential impact of a disproportionate levying of fees, we have based a scenario on the incidence of checking account fees. Checking account fees epitomize the problem facing lower and middle income households. These households are more likely to have checking accounts than any other single type of financial asset. They are likely to be forced to pay fees and the fees that lower income households pay are about the same as other groups, but the interest they earn on these accounts is lower.

Table 2 shows key characteristics of checking accounts which explain the way the burden of fees falls. The key to whether fees are paid in the GAO study is a minimum balance requirement. Approximately 82 percent of the institutions set this condition in 1985. The range of minimum required balances was \$300 to \$500 in both 1983 and 1985.

The first column of Table 2 shows that in 1983 the median holdings of all groups up to the middle income group fell in this range, suggesting that many of the households in these segments would be below the minimum. Indeed, it is the top ten percent who hold large amounts in checking accounts. This group is much more likely to earn interest and avoid paying fees (see the second and third columns of Table 2).

The amount of fees paid differs relatively little across income groups. The lowest income group paid \$41; the highest income group paid \$57 (the fourth column in Table 2).

The relative equality of fees paid reflects the fact that there is a relative equality in the percent of all checks written (see the ninth column of Table 2). The lowest income group wrote 12 percent of all checks, the highest income group wrote 17 percent.

The difference in fees paid is much smaller than differences in interest earned (see the fifth column in Table 2). The lowest income group earned \$28. The highest income group earned \$103. The large difference in asset holdings underlies this difference (see the tenth column in Table 2). The lowest income group held only 7 percent of checking account assets (in relatively small accounts); the highest income group held 36 percent of all checking account assets (in relatively large accounts). Indeed, the upper middle income groups earn sharply more than the middle, even though its median holding is not that much larger. This suggests that these households are better able to keep their balance consistently above the minimum.

TABLE 2:

CHECKING ACCOUNT DATA

	a	b	b	b	b	b	b	a	c
	MEDIAN	PERCENT	PERCENT	AVG. FEE	AVG. INT.	NET FEES	NET COST	PERCENT OF	PERCENT OF
	ACCOUNT	RAMMING	PAYING	NO INT.	NO FEE	FEE PAID	ALL CHECK.	1983 CHECKING	1984 CHECKS
	IN 1983	INTEREST	FEES	ACCOUNTS	ACCOUNTS	ACCOUNTS	ACCOUNTS	ACCOUNT ASSETS	WRITTEN
	(\$)	(%)	(%)	(\$)	(\$)	(\$)	(\$)		
LOWER	300	35	43	-41	28	-45	-11	7	12
LOWER MIDDLE	400	31	43	-48	52	-50	-8	17	22
MIDDLE	500	31	47	-49	59	-49	-6	21	22
UPPER MIDDLE	625	30	43	-49	88	-43	+5	18	26
UPPER	1700	44	20	-57	103	-35	+8	36	18

SOURCES:

a) R. B. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, Table 12.

b) U. S. General Accounting Office, Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation, July 1987, tables 3.1 and 3.2.

c) R. B. Avery, et al, "The Use of Cash and Transaction Accounts by American Families," Federal Reserve Bulletin, February 1986, Table 2.

These difference combine to create a very sharp difference in the net cost of checking (see Table 3). Looking at net fees paid, only for those accounts which paid fees, the lowest income group paid about 14 percent of the total, the highest income group paid about 9 percent.

If we were to include all checking accounts -- those on which fees were paid and those on which they were not -- the difference would be even greater. The two highest income groups had net earnings on their checking accounts. The three lowest income groups had net costs.

To model the incidence of fee increases, we have based our calculation only on the accounts which paid fees. In this way we estimate the share of total checking account fees paid by each income group. We have disregarded those checking accounts which paid no fees, whether or not they earned interest.

As Table 3 shows, the incidence of the net cost of checking with all accounts included is considerably more regressive than our estimate of net checking fees paid.^{5/} We have chosen the conservative approach of using fee paid only accounts because the magnitude of the cost increase associated with an increase in premiums to fund the bailout is likely to be so large as to make it difficult for banks to funnel all of it to less liquid accounts.

C. INCOME AND THE INCIDENCE OF INCOME TAXES

To consider taxes as a source of revenue for the bailout, we calculate the percentage of income taxes paid by each segment. The most recent data available is for 1986, but a projection for 1988 was made by the Congressional Budget Office.^{6/} We use the estimate for 1988 in this analysis since it incorporates recent tax reforms.

This approach assumes that the burden falls as the current income tax burden is distributed. In essence, it could be achieved as an across the board increase in taxes -- a surtax on income taxes paid. Obviously, Congress could target a tax increase as it sees fit by a differential surtax or other mechanism.

It should be noted that Federal taxes in general and income taxes in particular are progressive (see Table 4). The poorest fifty percent of the population earns about 18 percent of income and pays about 6 percent of income taxes. They pay about 12 percent of all federal taxes. The top ten percent earns about 36 percent of income and pays about 53 percent of income taxes. They pay about 42 percent of all federal taxes.

While the burden of income and total federal taxes are progressively distributed, excise and social insurance taxes are not. The poorest fifty percent pays a much larger share of excise taxes than their share of income. They pay a share of social insurance taxes approximately equal to their share of income. The wealthiest ten percent pay a much smaller share of social insurance and excise taxes than their share of income.

In this paper we model income taxes as a funding mechanism. We caution that a tax-based approach which degenerates into a deficit could have a very different impact. If excise taxes are raised to increase revenues, it could be regressive. Similarly, if program cuts are made, they could impact lower income households heavily.

TABLE 3:

ALTERNATIVE FORMULAS OF THE COST SHIFTING ARGUMENT
BASED ON CHECKING ACCOUNT FEES

	NET FEES, FEE PAID CHECKING ACCOUNTS	NET COST OF CHECKING, ALL CHECKING ACCOUNTS
LOW	.1440	.3447
LOWER MIDDLE	.2297	.3560
MIDDLE	.2831	.2993
UPPER MIDDLE	.2489	.0000
UPPER	.0943	.0000

SOURCES AND NOTES:

U. S. General Accounting Office, Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation, July 1987, Tables 3.1 and 3.2 are used to estimate fees paid per account. The proportion of the population holding accounts is taken from R. B. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, Table 12. See Table 3 and text for a discussion of the methodology for deriving exact proportions.

TABLE 4:

ESTIMATED DISTRIBUTION OF FAMILY INCOME AND FEDERAL TAXES, 1988

	INCOME	INDIVIDUAL INCOME TAX	SOCIAL INSURANCE	EXCISE TAX	TOTAL
LOWER	4.3	0.0	3.1	12.2	1.9
LOWER MIDDLE	13.9	6.2	15.1	20.8	10.3
MIDDLE	18.1	13.7	21.8	20.1	16.8
UPPER MIDDLE	28.6	27.0	25.3	26.4	29.0
UPPER	35.7	53.2	24.5	18.6	41.9

SOURCE:

Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987, Table B-1, for 1988 taxes. The third decile is split one-third for low income and two-thirds for lower middle income.

D. CONSIDERING OTHER FINANCIAL ASSETS

Just as Congress could selectively target an income tax increase, it would be possible for Congress to legislate specific levies on any of a variety of financial instruments to raise funds. As long as the tax was levied directly, financial institutions would have difficulty shifting costs between different categories of customers. If the levy were direct, they would also have little incentive to cost shift beyond what they currently do.

To suggest the difference between these various forms of levies we have estimated the distribution of various categories of liquid assets and all financial assets. Liquid assets include checking accounts, certificates of deposit, savings accounts, money market funds, and IRAs or Keogh accounts. Other financial assets included in the all financial asset category include savings bonds, stocks, bonds, non-taxable holdings and trusts.

In each case the share of an income segment is calculated by estimating the segment's holding of assets with the following general formulas.

Asset Holding of Segment	(AHS) =	Proportion of Population in Segment	X	Proportion of Segment Holding the Asset	X	Average Size of Segment Holding of Asset
--------------------------	---------	-------------------------------------	---	---	---	--

$$\text{Segment Share} = \frac{\text{AHS}}{1} \div \sum_{i=1}^5 \frac{\text{AHS}}{1}$$

III. RESULTS

A. THE INCIDENCE OF ALTERNATIVE FUNDING MECHANISMS

Table 5 shows the dramatic differences in impact that the various funding mechanism can have. Low income households would bear virtually none of the burden if income-taxes are used. They would bear as much as one-seventh of the burden, if an increase in premiums funneled through to low income households in the same way that the net costs of checking accounts have been placed on this group.

The lower middle class is in a similar situation. They could pay over one-fifth if funds are raised as checking account fees have been imposed. This is almost four times as much as they would pay under an income tax-based approach.

The middle income group would also bear a much smaller burden under an income tax-based approach. Their burden would be 28 percent under a fee approach and 14 percent under an income tax-based approach.

For the upper income groups, the incidence runs in the opposite direction. The upper middle income group is relatively indifferent to funding mechanisms. Its burden ranges from 25 percent under a premium approach to 27 percent under an income

TABLE 5:

PROPORTION OF BURDEN BORNE BY VARIOUS GROUPS

INCIDENCE BASIS

INCOME SEGMENT	^a	^b
	FEE PAID CHECKING	ESTIMATED 1988 TAX
LOW	.1440	.0010
LOWER MIDDLE	.2297	.0620
MIDDLE	.2831	.1370
UPPER MIDDLE	.2489	.2700
UPPER	.0943	.5320

SOURCES AND NOTES:

a) U. S. General Accounting Office, Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation, July 1987, Tables 3.1 and 3.2 are used to estimate fees paid per account. The proportion of the population holding accounts is taken from R. B. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, Table 12. See Table 3 and text for a discussion of the methodology for deriving exact proportions.

b) Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987, Table B-1, for 1988 taxes. The third decile is split one-third for low income and two-thirds for lower middle income.

tax-based approach. For the upper income group there is a huge difference. Under an income tax-based approach, they would bear over half the burden. Under a premium based approach, they would bear less than one tenth.

B. THE ABSORPTION ARGUMENT

One of the primary reasons given for not directly levying fees on specific financial instruments is that financial institutions might be forced to absorb some of the increase in premiums or other charges. The argument is that if they endure an increase in the cost of doing business in the face of competition, they might not be able to pass all of the costs through. The financial institutions, of course, insist that little, if any, such absorption is possible.

From the point of view of the lower and middle income groups, the whole argument is largely irrelevant.

The greater the competitive pressure in the marketplace which would force financial institutions to absorb the increases, the greater also will be the inclination to discriminate in passing through the burden of increased costs. The first response of financial institutions to absorb part of the cost increase will be to avoid raising fees or lowering interest rates on those accounts which are the most sensitive to price changes. Larger asset holders, who have greater flexibility, will be the first group shielded from the cost pass-through. This is especially true if non-S&L/bank financial instruments do not bear any part of the burden.

In order for the low income segment to be indifferent between this approach and an income tax-based approach, the financial institutions would have to absorb virtually all of it. For the lower middle and middle income segments to be indifferent, the financial institutions would have to absorb one-half to three-quarters of the increase.

C. SENSITIVITY OF THE INCIDENCE ANALYSIS TO INCLUSION OF SPECIFIC TYPES OF ASSETS IN THE FUNDING BASE

Table 6 shows the distribution of all liquid assets and total financial assets. The low income group clearly would prefer a broad-based levy on either of these categories of assets, as long as the financial institutions could not shift the burden through price discrimination. They would still bear a heavier burden than under an income tax-based approach.

The lower middle income group has a strong preference for tax-based approaches. Even levying fees directly on all financial assets would leave them paying two times as much as under an income tax-based approach.

Thus, the key to minimizing the burden on low income groups is to base the bailout on income taxes.

For the middle income group broadening the base to all financial assets or income taxes eases the burden. For each of these approaches the burden falls in the 12-13 percent range.

Thus, households in the bottom seventy percent of the income distribution have a strong interest in broadening the base to at least all financial assets and/or using income taxes as the source of funds.

TABLE 6:

ALL LIQUID AND FINANCIAL ASSETS COMPARED TO FEES AND INCOME TAXES

INCOME SEGMENT	INCIDENCE BASIS			
	^a FEE PAID CHECKING	^b ALL LQD ASSETS	^b ALL FIN ASSETS	^c TAX 1988 ESTIMATED
LOW	.1440	.0467	.0308	.0010
LOWER MIDDLE	.2297	.1733	.1182	.0620
MIDDLE	.2831	.1742	.1273	.1370
UPPER MIDDLE	.2489	.2612	.2131	.2700
UPPER	.0943	.3446	.5106	.5320

SOURCES AND NOTES:

a) U. S. General Accounting Office, Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation, July 1987, Tables 3.1 and 3.2 are used to estimate fees paid per account. The proportion of the population holding accounts is taken from b, below.

b) R. B. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, Table 12. For all financial instruments. See Table 2 and text for a discussion of the methodology for deriving exact proportions.

c) Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987, Table B-1, for 1988 taxes. The third decile is split one-third for low income and two-thirds for lower middle income.

While the upper middle income group is relatively indifferent between funding mechanisms, the upper income group has a strong interest in having financial institutions determine the allocation of costs. They are the beneficiaries of the competition for funds.

Utilizing the categories of all liquid assets and all financial assets in the basic analysis glosses over possible distinctions between types of assets. There are differences in the incidence of specific subcategories. A mechanism could be enacted which would ensure that a levy was placed on any (or every) specific type of asset.

Table 7 shows the distribution of the subcategories of asset of the scenarios considered above. It generally confirms the earlier conclusions. Lower income households tend to hold less of the "other financial assets" and more of the liquid assets, although savings bonds are one clear exception.

In the aggregate, the difference in the liquidity of holdings is quite dramatic. The low income group has four-fifths of its assets in liquid holdings. The upper income group has less than one fifth.

The lower middle and middle income segments appear to hold Certificates of Deposit more than other instruments. Stocks, bonds, non-taxable assets and trusts are highly concentrated in the upper middle and upper income segment.

IV. POLICY DISCUSSION

Incidence cannot be automatically equated with either equity or efficiency. Knowing who will pay does not tell us who should pay to make things fair or to achieve the most productive outcome. While progressivity in the burden can be considered a legitimate social objective in its own right, that goal in itself might not suffice to tip the scales in favor of the broader funding approaches indicated by the incidence analysis.

However, other factors confirm that this is the correct policy approach.

First, a significant part of the impact of the savings and loan crisis was an escalation of interest rates caused by .pn 21 competition for funds and the efforts of failing thrifts to generate cash flow. The extremely high interest rates that resulted were much more likely to have been enjoyed by larger asset holders because they can meet the conditions required to obtain the higher interest rates.

The data reviewed above indicate this in the size of assets and the distribution of fees. The lower income groups hold smaller accounts and are less able to hold non-liquid assets which are typically rewarded with higher interest rates.

Second, one goal of the bailout that has been mentioned is to reduce the tendency for funds to move from one type of institution or one category of assets to another to avoid bearing (a phenomenon called disintermediation). If the base is broadened, the likelihood that this will occur is diminished.

TABLE 7:

THE DISTRIBUTION OF FINANCIAL ASSETS

LIQUID ASSETS						
INCOME SEGMENT	CHECKING	SAVINGS	MONEY MARKETS	CDs	IRA/ROTH	ALL LIQ ASSETS
LOWER	.0735	.0510	.0195	.0525	.0165	.0467
LOWER MIDDLE	.1717	.1500	.1300	.2752	.0070	.1733
MIDDLE	.2112	.2185	.1054	.2352	.1369	.1742
UPPER MIDDLE	.1799	.2060	.1714	.1561	.2729	.2612
UPPER	.3630	.3649	.4930	.2810	.4067	.3446

OTHER FINANCIAL ASSETS						
	SAVINGS BONDS	STOCKS	BONDS	NON- TAXABLES	TRUSTS	ALL FIN ASSETS
LOWER	.0439	.0159	.0000	.0000	.0356	.0308
LOWER MIDDLE	.0900	.0740	.1000	.0756	.0290	.1182
MIDDLE	.2132	.0630	.0906	.0089	.0905	.1273
UPPER MIDDLE	.2072	.0982	.0762	.0476	.1947	.2131
UPPER	.3569	.7400	.7324	.0679	.6502	.5106

SOURCES AND NOTES:

a) R. B. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, Table 12. For all financial instruments. See Table 2 and text for a discussion of the methodology for deriving exact proportions.

b) Martha Shelly and Robert Kallish, "Individual Income Tax Return, Preliminary 1986 Data," SOI Bulletin, Winter 1987-88, Table 1, for 1986 taxes.

c) Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987, Table B-1, for 1988 taxes. The third decile is split one-third for low income and two-thirds for lower middle income.

Third, broadening the base also has the benefit of potentially chilling the inclination of financial institutions to price discriminate in passing the burden through. To the extent that cost pressures are reduced, financial institutions will feel less compelled to price discriminate to meet the competition.

The inclination of financial institutions to price discriminate also argues for a direct levy by the federal government, rather than an assessment on the institutions, who then decide how to raise the funds. Following their inclinations, they will impose the burden on the lower income segments.

By this line of reasoning, one clearly arrives at taxes as the logical conclusion. They provide a relatively progressive, broad based approach to funding. They deny the financial institutions the ability to discriminate.

A tax-based approach is progressive, however, only if it is funded in that fashion. If budget deficits rise and cuts take place in programs which are targeted at lower income groups, then this avenue can be as regressive, if not more regressive than, any funding approach that remains within the financial system.

FOOTNOTES

1/ In economic and tax literature this is referred to as incidence analysis. D. W. Pearce, The Dictionary of Modern Economics (Cambridge: MIT Press, 1984), p. 198, defines incidence as follows

Incidence of Taxation. This refers to the eventual distribution of the burden of a tax. It refers to those who suffer a reduction in their real income resulting from the imposition of a tax.

2/ R. B. Avery, et al, "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984; U. S. General Accounting Office (GAO), Banking Services: Changes in Fees and Deposit Account Interest Rates Since Deregulation, July 1987. See also, Board of Governors, Federal Reserve System, Bank Service Charges and Fees: Their Impact on Consumers.

3/ Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987, Table B-1, certainly shows that this is the direction of changes in the distribution of income.

4/ Pearce, The Dictionary..., p. 198, notes the difference between the incidence and the impact of a tax.

The incidence of a tax may be quite different from the impact of taxation. Thus a sales tax may actually be levied on a wholesaler or retailer but he is able to pass on the burden of the tax in part to his customers. In the case of a specific sales tax the incidence will depend on the elasticity of the supply and demand curves. The more inelastic is demand and the more elastic is supply the greater the burden on the consumer.

In essence, we argue here that the lower income groups have a lower elasticity of demand for liquid assets and that is why they have borne the heavier burden. The narrower the financing base, the larger the price increase on target liquid assets relative to other assets.

5/ The GAO, Banking Services..., Table 3.4, report shows a similar pattern of price or interest rate discrimination for other types of accounts. Thus, lower income groups were found to be the least likely to have the types of accounts which earn the higher rates of interest, even though they are checking-like accounts. They simply do not have the necessary assets or cannot tolerate the restrictions on liquidity.

6/ CBO, The Changing Distribution..., and Martha Shelly and Robert Kallish, "Individual Income Tax Return, Preliminary 1986 Data," SOI Bulletin, Winter 1987-88, Table 1, for 1986 taxes.

Mr. STARK. Ms. Miller, the only reason I would have the temerity to suggest that your time is expired is because you are in this instance preaching to the choir. And you probably ought to hope that your testimony ends before other members of the committee return who would not agree with you as much as the people sitting here.

Ms. MILLER. Yes, I wish they were here.

Mr. STARK. You are on a role. And also—well, let me now see if Ms. Michelle Meier, who is counsel for Government affairs at Consumers Union would like to add something.

STATEMENT OF MICHELLE MEIER, COUNSEL FOR GOVERNMENT AFFAIRS, CONSUMERS UNION

Ms. MEIER. Thank you, Congressman Stark.

And I am pleased to be here today. I commend the committee for holding these hearings on one of the most pressing budgetary issues now facing us. And I particularly commend the committee and its chairman for recognizing that the public has such a huge stake in the outcome of the FSLIC crisis by inviting this panel of public interest representatives to communicate our concerns and suggestions regarding how to deal with it.

We only hope that however the crisis gets resolved that it will reflect our concerns and the public interest generally.

You will see from our written testimony and my testimony that Consumer Federation of America and Consumers Union have many common threads in our approach to the FSLIC crisis. We also have addressed the question of who should pay and in that regard have very serious criticism of the Bush proposal.

We believe that our answer—and your answer—to the question of who should pay should be governed by the basic fundamental principle of progressivity. Those who are least fortunate among us should not be forced to bear much of the burden of bailing out FSLIC and those who are most able to pay should shoulder most of that burden.

Unfortunately, the Bush proposal flies in the face of this fundamental principle in two ways. One is the premium increase. As Ms. Miller stated, it is very, very likely that any increased premium—and in 1990 the S&L's increased premium to bail out FSLIC will total \$2.3 billion approximately—will be passed through to low balance account holders. And those low balance account holders are low income consumers.

This analysis is based on our looking at the demographic patterns associated with depository institution account holders and looking at the pricing structure of depository institutions since deregulation occurred a couple years ago. In 1985 Consumers Union did a survey of banking fees in over 100 banks throughout the country and came to the conclusion that already banks are disproportionately passing through their cost to low balanced consumers relative to the costs borne by upper balanced consumers.

So the bottom line is that we do not think that the bailout should come from increased premiums. That is very, very regressive.

The Bush proposal is also regressive in that it fails to identify any new revenue stream—or new tax to be less euphemistic—to

pay for this bailout. Obviously the bailout is going—even in the off-budget approach that the administration has proposed, is going to present tremendous burdens on the Federal budget.

Even under the optimistic assumptions of the administration's cost projections, between 1989 and '94, the Federal Government's share of the costs will total at least \$28.1 billion. If we eliminate the insurance premium increase, we are facing—or the Federal Government is facing—a cost of over \$43 billion. And these amounts are likely greatly understated.

Compare those costs to the estimated 1989 budget for the entire HUD-assisted housing program of \$7 billion. So the bottom line again is that the Bush proposal is regressive because, unless we can identify some new revenue stream, the severe budgetary pressures posed by the FSLIC bailout is likely to cut into the budgets of important social programs that benefit the most needy among us.

We are here before this committee to suggest that you look to—help us look to—ways to raise new moneys for the FSLIC bailout that will be progressive. We are also here to suggest ways that the committee can help us in linking the S&L insolvency solution to the solution of low and moderate income housing needs.

As the S&L industry has declined, so has our commitment to low and moderate income housing. Affordability and availability of low and moderate income housing was substantially declined over the past decade.

The S&L industry in its post-bailout form should be dedicated to helping solve this problem of unmet needs in low and moderate income housing. This will require a subsidy. You cannot expect the S&L industry to provide low and moderate income housing without some subsidy from outside the industry.

We have several proposals for providing that subsidy. One is lowering the ceiling on the mortgage interest deduction in a way that would not be such a political hot potato and in a way that would not impact middle income homeowners, but the wealthiest among us who gain a substantial housing subsidy while the least fortunate among us have such great needs.

So we hope you will look with us at that subsidy, the mortgage interest deduction, lowering it in a way that would only impact the wealthiest homeowners, and other ways that would shift the housing subsidy now given to the wealthiest among us to support a subsidy program for low and moderate income housing needs.

Thank you very much.

[The statement of Ms. Meier follows:]

TESTIMONY OF
MICHELLE MEIER
COUNSEL FOR GOVERNMENT AFFAIRS
CONSUMERS UNION
before the
HOUSE WAYS AND MEANS COMMITTEE
on the
FSLIC BAILOUT
March 9, 1989

Consumers Union¹ appreciates the opportunity to testify on one of the most pressing budgetary issues now facing us-- the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). We commend you, Mr. Chairman, for recognizing the public's large interest in this issue by inviting a panel of public interest representatives to these hearings. Hopefully, this will mark a turning point in the FSLIC debate, which has been dominated so far by the industry and the regulators.

The amount of public money needed to return the S&L fund to solvency is staggering. Although we appreciate the Administration's interest in moving quickly on its proposed bailout legislation, several public policy issues must be fully considered before we commit such a huge amount of public funds to rescue a system that has obviously failed to serve its public purpose.

The public has a huge stake in 3 basic issues raised by the FSLIC disaster:

- 1) Who will pay to shore up both FSLIC and the FDIC so these agencies can effectively act to close or merge the hundreds of institutions that will otherwise make growing demands against the public insurance funds?
- 2) What public purpose should insured depository institutions serve in the future to justify this huge public bailout and continuing public insurance?
- 3) What regulatory mechanisms should be established to prevent another huge bailout in the future?

These are important questions that deserve serious and full consideration by Congress. No bailout legislation should move until the public and all interested parties have had a chance to discuss and respond to alternative proposals to address them.

Our testimony today discusses the first 2 issues, particularly as they relate to the concerns of this Committee.

WHO SHOULD PAY AND HOW?

The Principles of Progressivity and Prudence Should Determine Our Response to These Questions

We wholeheartedly support the Administration's proposal to beef up our criminal and civil enforcement capacity to hold those responsible for the huge waste of publicly-insured funds accountable for their misdeeds. Unfortunately, it is clear that any sums we recover in restitution will come too late and in insufficient amounts to meet our enormous needs.

Even relying on the optimistic assumptions underlying the Administration's cash flow projections, the Administration's proposal will require \$28.1 billion in federal outlays between 1989 and 1994.² If we eliminate increased S&L premiums as a supplemental revenue raising mechanism, as we propose, the budgetary impact over the same period will total approximately \$43.7 billion.³ Even this figure is unrealistically low because of the low interest rate assumptions on which it relies.⁴

Now that we are all used to dealing in tens of billions of dollars, the enormous budgetary impact of these FSLIC demands alone may not be fully appreciated. To get a better handle on how this huge sum of money may affect important social programs, compare \$43.7 billion to the estimated fiscal year 1989 budget authority for all HUD-assisted housing programs -- a meager \$7.2 billion.

From a public policy perspective, there is one overriding principle that should govern our search for a "quick" source of revenue to finance these extraordinary costs -- that principle is progressivity. We should not disproportionately burden those segments of society least able to contribute toward such a huge public demand for funds. This means we should look to our wealthier citizens to contribute most heavily. It also means we should not indirectly burden our least wealthy citizens by dipping into federal social programs that help them meet the basic necessities of life.

Another important principle is prudence. If we are going to borrow to raise the needed funds, we should select the cheapest credit terms that are practically feasible. The public does not deserve spendthrifts in Washington.

The Bush Proposal Is Not Progressive

Unfortunately the Bush proposal ignores the principle of progressivity in two ways: First, it relies heavily on an increased deposit insurance premium, which, at best, will be passed through proportionately, rather than progressively, to all bank and S & L customers. More likely, it will be passed through in a way that disproportionately burdens low and moderate income consumers.

Second, it also relies heavily on federal treasury contributions to meet the interest and other direct and indirect costs of the bailout. In these days of tight federal budgets, such extraordinary federal outlays must have an extraordinary revenue stream to support them. Otherwise, we will face two unacceptable choices: an increased budget deficit or budgetary cuts in programs for the most needy. Aside from the regressive industry premium increase, the Bush proposal does not identify any new revenue stream to support these extraordinary costs.

The Bush Proposal Is Not Prudent

The Bush proposal also scores poorly in terms of fiscal prudence. It raises \$50 billion in an off-budget agency that can only raise funds at prices that are at least 25 basis points more than what the federal government would pay if it raised the funds directly. If we are going to go "off-budget," we might as well take this step in the cheapest way possible by allowing Treasury to issue the bonds directly and declare the borrowing to be "off budget."

Second, the bonds issued under the Bush proposal will extend for 30 years, rather than a shorter time period that would reduce their financing costs. The Administration's rosey assumptions about future interest rates would suggest that the 30 year interest costs on these bonds will total \$110 billion.⁵ Using more realistic assumptions, the Chairman of the House Banking Committee has estimated that the interest costs on the bonds will cost closer to \$150 billion.⁶

Increased Premiums Are A Highly Regressive Revenue Raising Approach

Several weeks ago, the Administration's "trial balloon" user fee proposal was immediately shot down as a regressive and unfair tax on innocent consumers. The increased premium proposal is the same type of regressive tax, but it is disguised in sheep's clothing.

Under the Administration's proposal, the S & L industry's 1990 increased premium contribution to FSLIC for the bailout will total \$2.3 billion, an amount that is expected to increase each year. We anticipate that the industry will pass through most of these increased costs to their customers, rather than their shareholders.

This conclusion is based on two considerations: First, more than half of the S & L industry is composed of institutions organized in the mutual form -- these institutions could not pass through the added costs to shareholders. Second, although the balance of the industry could theoretically pass through their costs to shareholders, most of the industry will be hard-pressed to take the increased costs from retained earnings and still meet the substantially increased capital requirements that any bailout legislation should contain.

The regressive impact this premium pass-through will have is evident from statistics on 1) industry pricing patterns since interest ceilings on deposits were lifted and 2) the demographics of bank and S&L accountholders. Using these statistics, the Consumer Federation of America has prepared an incidence analysis, which compares the relative burden born by various income groups under a premium revenue raising mechanism versus the current federal income tax system. On the assumption that the industry will distribute the increased costs among accountholders in a way that follows historical pricing patterns, their analysis indicates that the increased premium will be exceptionally regressive.

The current regressivity of deposit account pricing structures is also reflected in analyses prepared in 1985 by my organization, which shows that consumers with lower balances (\$500) bear a higher percentage of industry costs in the deposit account price structure than consumers with higher balances.⁷

Although we derive some emotional satisfaction in saying, "Let the industry pay," that is unfortunately a simplistic formula that only hurts those least able to pay. The Administration was accurate a few weeks ago in calling this revenue raising scheme a user fee, and the critics of the user fee proposal were correct in rejecting it as unfair and regressive. We urge Congress to face this reality squarely, and, in resolving today's problems, to look to alternative fundraising mechanisms that do not involve a premium increase.

Congress Should Choose from A Variety of Progressive Fund Raising Options

There are several ways to raise additional income to meet the extraordinary costs of the FSLIC bailout without affecting important social programs or increasing the federal deficit. We recommend that Congress seriously consider all options.

In particular, we hope that this Committee will consider the merits, relative to other alternatives, of increasing the tax rate paid by those in the highest income category to at least equal the tax rate paid by those in the second highest bracket. As this Committee is aware, because of the phaseout of the 15% bracket and personal exemption, single taxpayers earning between

\$44,950 and \$104,510 pay at a marginal tax rate of 33%, while those earning over \$104,510 only pay at a marginal rate of 28%.

This option would not only eliminate a serious glitch in the progressivity that otherwise governs the tax code. According to estimates provided in 1988 by the Congressional Budget Office, it would also raise about \$30 billion over a 5 year time period.⁸ This alternative, and others that should be explored, could fund a large part of the bailout -- progressively.

WE MUST REDEDICATE THE S&L INDUSTRY TO SERVING LOW AND MODERATE INCOME HOUSING NEEDS

The financial decline of the S&L industry, and its federal insurer, has been accompanied by a parallel decline in the availability and affordability of housing for our low and moderate income citizens. During the past several years, the unmet housing needs of the lower-income members of our society have drastically increased. For example, the following figures illustrate the increasing gap between those eligible for federal rental assistance and those who receive it.

INCOME-ELIGIBLE BUT NON-SUBSIDIZED RENTER HOUSEHOLDS

Rental Households with Incomes Under \$5,000 Receiving No Rental Assistance

1974: 2.2 million households

1987: 3.2 million households

Rental Households with Incomes In the \$5,000 to \$10,000 Range Receiving No Rental Assistance

1974: 3.8 million households

1987: 4.7 million households

Source: 1988 Report of the
National Housing Task Force

Additionally, there are an estimated 1.0 million families on waiting lists for public housing, and some lists have been closed to new applicants.⁹

Given the historic mission of the S&L industry to supply housing finance for our population, we believe that any resolution to the FSLIC crisis should also address the pressing housing needs of those with low and moderate incomes. It is shameful that the S&L industry has squandered \$90 billion in insured deposits while the unmet housing needs of our population have grown dramatically. It would be more shameful if we bailed out the industry without firmly re-establishing that its purpose is to help meet these needs. Publicly insured depository institutions, because they are publicly insured and chartered to serve a public purpose, should be selected as the delivery system for subsidized single and multi-family housing loans targeted to low and moderate income homeowners and renters.

We come to you, Mr. Chairman, and this Committee because any proposal to commit insured depository institutions for this type of specialized lending will require a source of revenue outside the industry to provide some of the subsidies needed to make it workable. We cannot look to the industry for the entire subsidy because it needs to be profitable and strong to serve this important public purpose.

We urge this Committee to support this goal, and to help us identify and promote a new revenue source that could provide this subsidy. One source of revenue for the subsidy, which many have already proposed, would be a tax on all financial service providers, including mutual funds, insurance companies, and stock brokers, which would tap a very progressive tax base. We hope you will seriously explore the viability of this option.

Another alternative has a direct link to the concept of federally subsidized housing. By reducing the current subsidy given wealthy homeowners through the mortgage interest tax deduction, we could raise substantial funds to subsidize the housing costs of those in greatest need.

For example, according to 1988 estimates from the Congressional Budget Office, we could raise about \$10 billion in revenues over 5 years, or \$2 billion each year, by capping the mortgage interest deduction at \$20,000 per year on a joint return (\$12,000 for a single person).¹⁰ This would still allow full deductibility on a mortgage loan balance up to \$200,000 (\$120,000 for a single person).¹¹ In fact, CBO estimates that this option would affect less than one-half of one percent of all taxpayers.

Alternatively, we could raise a significantly smaller amount by limiting deductions on debt to acquire second homes, most of which are vacation homes. Under one version of this option, we could require interest deductions for second homes to qualify under the current \$100,000 interest limit on home equity loans secured by the primary residence. This would raise about \$2 billion over 5 years.¹² Obviously, if the \$100,000 ceiling for home equity loans were lowered, additional revenues could be raised.

CLOSING

The benefits of public insurance are distributed to favor those with wealth: persons with high insured balances earn high rates of interest; those with \$1,000,000 can divide their wealth into \$100,000 bundles -- all of it insured. This only underscores that the bailout financing scheme should be progressive.

The S&L bailout package must also address the housing needs of our low and moderate income citizens. Publicly insured institutions should play a role in meeting those needs, but some amount of subsidy from outside these institutions is required. In light of the pressing need for additional low and moderate income housing subsidies, it is extremely difficult to justify the large federal housing subsidy for the extremely fortunate among us -- a class whose subsidy overshadows that of all others. While still protecting middle income homeowners, we can modify this subsidy by shifting some of it to the most needy.

FOOTNOTES

1. Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education and counsel about consumer goods and services and the management of family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications and films. Expenses of nonrestrictive, noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 3.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.
2. Appendix to Testimony of Treasury Secretary Nicholas Brady before the Senate Banking Committee, Feb. 22, 1989.
3. The Administration estimates that the increased S&L premium will raise \$15.6 billion between 1989-94. The \$43.7 figure is derived by adding \$15.6 and \$28.1.
4. The Appendix to Secretary Brady's February 22 testimony (see note 2, above) indicates that the Administration's estimates assume the REFCORP bonds will have a 7.9% interest rate in FY 1990, and a 6.5% interest rate in FY 1991.
5. At the time this testimony was prepared, the Administration has only publicly released cost projections through 1999. This 30-year cost estimate was derived using its 89-99 weighted average interest rate assumptions.
6. See, "Making the Bailout Workable: An Analysis of the Administration's Plan to Resolve the Thrift Crisis," Feb. 22, 1989.
7. See, "Consumer Reports," Sept., 1985 at 513.
8. CBO, "Reducing the Deficit: Spending and Revenue Options: A Report to the Senate and House Committees on the Budget," Part II at 287.
9. Report of the National Housing Task Force, March 1988 at 7.
10. CBO report (see note 8 above) at 320.
11. Assuming an average mortgage interest rate of 10%.
12. CBO report (see note 8 above) at 321.

Mr. STARK. Thank you very much.

Ms. Pernell, president of the DC ACORN, would you like to proceed.

STATEMENT OF IRMA PERNELL, PRESIDENT, DC ACORN, THE ASSOCIATION OF COMMUNITY ORGANIZATIONS FOR REFORM NOW

Ms. PERNELL. Good afternoon. My name is Irma Pernell. I am representing ACORN, the Association of Community Organizations for Reform Now. I live in Washington, D.C. I am president of the D.C. Chapter of ACORN.

ACORN is the country's largest grassroots membership organization of low and moderate income people. ACORN was founded in 1970 in Little Rock, Arkansas, and since then has grown to include 75,000 member families in 40 cities, including a big and very active chapter in Chicago.

ACORN is a multi-issue, multi-racial organization. In addition to other campaigns, ACORN has been working on banking issues for the past several years, doing everything in our power to stop red-lining and get banks and S&L's to begin lending our neighborhoods so that we can begin to revitalize our communities.

Congressman Stark, ACORN appreciates the opportunity to appear before your committee today to present some of our proposals on how Congress should approve the bail-out of the Nation's savings and loan industry.

ACORN is helping to pull together a large national coalition of community groups, labor unions, churches and economists to develop a citizens' alternative to President Bush's S&L rescue plan. The coalition, called the Financial Democracy Project, is circulating a set of principles all over the country for discussion and endorsement, and the response has been impressive.

The coalition is also finalizing a set of specific proposals on the S&L bail-out to bring to Congress. I will discuss two of those proposals here today.

First, we strongly oppose any plan which will require average Americans to pay for most or all of the costs of the bail-out. We did not cause the S&L mess, we did not benefit from the S&L mess, and we will not pay for the S&L mess. We will not tolerate any further cuts in social programs like health care, education, housing and job training.

The Reagan administration has already slashed the safety net for low and moderate income Americans to ribbons. Millions of people would have been lifted out of poverty with the help of such Federal programs over the past 8 years. We must begin today to rebuild them.

Any bail-out financing plan which does not pay most of the bill over a short period of time with new sources of money will take a crippling bite out of the Federal Treasury. A detailed list of alternative sources of funds is included in my written testimony. It is largely up to you, Chairman Rostenkowski, and the other members of this committee, to take the initiative on the problem.

The Government must pass special new taxes now to pay off the savings and loans' debts now, so that our Nation does not fall sev-

eral hundred billions of dollars further in debt. The money must come from taxes which target the Nation's richest people and those institutions directly involved in the financial free-for-all of the Reagan years.

Today, in the Washington Post there is an article, "Public Views Could Aid Democrats, Poor Find," and a finding is that 82 percent of those surveyed supported raising income taxes for those with incomes larger than \$80,000 and 59 percent support a 33 percent top tax bracket for those with incomes larger than \$150,000. Make those who went to the party pay for the party. We insist. Let those who went to the party pay for the party.

Second, we demand that any rescue of the S&L must also result in damaged parts of our Nation's economy, particularly housing. Savings banks were chartered to help fulfill America's commitment to decent affordable housing for all citizens. As the S&L industry has fallen on hard times, homelessness has grown and homeownership has declined. Young families have been hit especially hard. We are calling on Congress to set up a mechanism to provide a much lower rate of moderate interest for all first-time homebuyers in low and moderate income housing developments.

We insist that the Federal Home Loan Banks be put to work providing housing for those who need it. We demand an end to redlining by the savings and loan industry, and we want the Federal Government to immediately make available vacant housing to the inventory of FSLIC and FADA for victims of foreclosure, substandard houses and homelessness.

We must make sure that Congress and the President do more than just throw money at broken down banks. The country must take this opportunity to rededicate the banking system to an important public purpose. Banks must become, at a minimum, institutions that contribute to the real credit needs of local communities, that don't discriminate, that don't redline, and that do live up to their obligations as cooperative citizens.

Thank you.

Mr. STARK. Thank you very much, Ms. Pernell.

[The statement of Ms. Pernell follows:]

**Testimony Presented for
ACORN
The Association of Community Organizations for Reform Now
by Irma Pernell
President of DC ACORN**

**to
Honorable Dan Rostenkowski, Chairman
Ways and Means Committee
US House of Representatives**

March 9, 1989

ACORN appreciates the opportunity to testify today before the House Ways and Means Committee on the principles and proposals we believe should guide the bailout of the nation's savings and loan industry. We commend Chairman Rostenkowski and other members of the committee for moving beyond the small circle of "experts" who have dominated the S&L debate to seek suggestions from a broader range of concerned citizens.

ACORN, the Association of Community Organization for Reform Now, is the country's largest organization of low and moderate income people. Founded in Arkansas in 1970 by a group of welfare mothers, ACORN has grown to include 75,000 member families in 26 states. ACORN groups are first organized at the neighborhood level to work for neighborhood improvements. As a national organization, ACORN is governed by an Association Board, composed of two delegates elected from each state. The Association Board is responsible for the overall direction of ACORN, for national campaigns and policy decisions.

ACORN is a multi-issue, multi-racial organization. Every day, ACORN members work through neighborhood groups to win improvements in our local communities, and also come together through citywide and national campaigns tackle larger, common problems. ACORN members address a range of issues, including expanding and preserving the stock of low income housing, fighting rape; providing jobs for the long-term unemployed; removing barriers to voter registration; and improving education, health care, and police protection.

Since 1985 ACORN has been fighting to force national and local banks to improve their lending in our neighborhoods. ACORN has met with officers of more than 40 banks concerning bank compliance with the Community Reinvestment Act (CRA) and as an outcome, has negotiated 25 CRA agreements in which lenders have agreed to make more than one-half billion dollars available on special terms in low and moderate income neighborhoods over the next two years. ACORN is also fighting to push reforms of CRA and related laws through Congress. ACORN's involvement in the S&L bailout issue is a direct outgrowth of our banking campaign.

In our testimony today, we will concentrate on only one of the many problems which Congress must wrestle with in setting the nation's banking system back on its feet -- the problem of **who should pay?**

ACORN is helping to form a national coalition of organizations and individuals who are brought together by common beliefs on what constitutes a just and adequate solution to the thrift crisis. The coalition, called the Financial Democracy Campaign, is composed of hundreds of community groups, labor unions, church affiliated organizations, farm groups, in addition to a host of the country's most respected and gifted scholars. The coalition has finalized a set of principles and is coming to consensus on detailed remedies. These were presented to Congressman Gonzalez, Chair of the House Banking Committee, at a large public event last week. What we will say today is strongly endorsed by a quickly multiplying group of activists around the country.

The savings and loan crisis is one of the worst financial calamities ever to strike our nation. In our view, a resolution of this crisis will be just only if it protects the interests of nonrich depositors, ordinary taxpayers and mortgage borrowers. It will be lasting only if it establishes structural and supervisory changes that restore public priorities to the financial industry and guarantee that such a calamity will never occur again.

We insist that cleaning up the ruinous mess in the savings and loan industry be guided by several principles, including:

Make the beneficiaries pay. The main financial burden of making good the government's guarantee to insured depositors should not fall on ordinary taxpayers, most of whom are net debtors and losers in the broad process of financial deregulation. Instead, the cost ought to be borne by the winners,

those who have profited from the instable financial conditions, unprecedented interest rates and huge transfers of wealth that the government fostered through the deregulation of finance.

There's plenty of blame to go around for the sorry state of the savings and loan industry. Regulators, Congress, two administrations, the industry and economic forces all played a part in the great collapse. Ordinary taxpayers, on the other hand, neither contributed to the industry's problems nor realized an overall gain from the thrifts irresponsible behavior or from the broader process of financial deregulation.

Financial deregulation meant bad borrowing, bad lending, and bad supervision for the thrifts. But most of all it meant high real interest rates -- the highest in this century according to the Federal Reserve. Those rates have handcuffed small business, wounded various sectors of the economy and effected a tremendous transfer of wealth from borrowers to creditors. It is incredible that ordinary taxpayers, most of whom are in debt, should be asked to pay an unprecedented price for the ghastly consequences of financial deregulation.

Instead of punishing the victims, we propose that the major financial responsibility for bailing out the Federal Savings and Loan Insurance Corporation (FSLIC) should be assigned to those who contributed to and benefited from the excesses associated with deregulation. Regardless of who pays for the damage, we believe that the FSLIC's accounts should be settled in the most straightforward manner possible -- no hidden or needlessly stretched out costs, no accounting gimmicks, no wishful arithmetic which results in paying much more later than somewhat less now.

We recommend that a bailout of FSLIC be spread out over a relatively short amount of time (no more than 10 years) and transacted on the federal budget. It should anticipate the adverse impacts of rising interest rates, a downturn in the business cycle, additional insolvencies in the savings and loan industry and potential deposit outflows and asset recovery problems.

As the General Accounting Office has noted, attempting to bail out FSLIC with off-budget long bond financing is a recipe for decades of ballooning costs. Taking the bailout off-budget, as President Bush proposes, will significantly increase the interest payment on long term bonds since those securities would not be backed by the full faith and credit of the federal government. Recently, a House Banking Committee staff report estimated that financing costs on Financing Corporation (FICO) and proposed Resolution Financing Corporation (REFCORP) bonds would amount to \$180 billion out of a total \$335 billion pricetag over thirty years. The report reckoned that the same bailout would cost \$100 billion if paid over ten years.

While it is impossible to precisely forecast the economic conditions under which a bailout will be conducted, it is only prudent to err on the conservative side and to narrow the time horizons in which economic projections are made. Rosy, hazy projections -- and the inadequate FSLIC recapitalizations they rationalized in the past--led directly to the massive disintegration of the S&L industry today. Having witnessed those mistakes so recently, we should know not to repeat them.

We recommend that since rapid liquidation is the least expensive way to dispose of insolvent S&Ls (and the best way to contain future costs), the Congress should directly appropriate sufficient funds to close down these institutions immediately and pay off their depositors. These funds should be included in the federal budget and be raised from a combination of sources that would provide sufficient revenue to cover resolution costs in ten years or less.

The most prominent funding sources we recommend include the nation's financial intermediaries and largest wealthholders, particularly those that exacerbated and/or benefited from the plight of the thrift industry. Specifically, we propose that revenues be tapped from the following sources to

finance the savings and loan bailout:

- proceeds from liquidation of insolvent S&Ls
- retained earnings from the twelve district Home Loan Banks
- increased deposit insurance premiums for thrifts and commercial banks. Deposit insurance fee increases should be progressively tiered; higher fees should be assessed against larger accounts under \$100,000; smaller fees should be assessed against smaller accounts in order to forestall regulated depositories from passing their costs on or curtailing banking services to small savers. A portion of revenues from these fee increases should be devoted to the bailout while the remainder enhances the strength of depositories' insurance funds.
- A Financial Markets Stabilization Fund that fathers reserves from all firms, regulated, unregulated or semi-regulated, doing financial business in the United States. Using its reserves, the Fund would provide emergency liquidity to revive, merge, close down troubled financial units and segments, starting with insolvent thrifts. Funded and available for use by all financial units, the Fund would help minimize the competitive advantages and disadvantages inhering to any bailout or liquidation by spreading its costs throughout the entire financial sector--thereby lowering the cost to each segment.
- One-time fees levied on financial firms such as money brokers, securities firms, insurers, appraisers and accounting firms that materially contributed to S&L insolvencies. Each of these segments of the financial services industry--by providing "hot money" to hopelessly broke thrifts (thereby bidding up the entire industry's costs of funds), misrepresenting the value of thrift assets, misstating the financial condition of S&Ls and other means--had a significant hand in the savings and loan disaster. Each should be part of a solution to the disaster.
- A special-purpose tax on interest income earned by foreign investors in this country. These earnings are currently untaxed.
- Tax receipts collected by making the mortgage interest tax deduction more progressive--e.g., by lowering the current ceiling of \$1 million or by eliminating the deduction on luxury second homes.
- Tax receipts collected by raising the personal income tax rate on individuals in the highest income tax bracket. These persons--who make up the wealthiest one percent on the population--realized a bonanza of interest income as a direct result of financial deregulation. They currently pay a lower marginal rate (28 percent) than individuals in the next highest bracket (who pay a marginal rate of 33 percent). We recommend that the marginal rate for the highest bracket be raised to 38 percent and that part of the additional revenues be used for the S&L bailout.

The net effect of tapping these revenue sources would be to more evenly distribute the burden of an S&L bailout among those most able to pay (i.e. those whose earnings have soared since financial deregulation) and to minimize the burden on ordinary taxpayers. This assortment of revenues would also minimize the ability of any segments of the financial services industry to gain or lose competitive advantages from a bailout and would partially define the public obligations that financial entities must fulfill in return for the public protections built into the financial marketplace. Finally, some of these revenues would unmistakably assert that a price must be paid for the kind of behavior that helped sink a large portion of the S&L industry.

We recommend that the federal government should revisit and improve the terms of FSLICs 1986 assistance agreements. In 1988, FSLIC committed upwards of \$38 billion in assisted mergers and acquisitions that handed control of huge S&Ls to takeover artists like Robert Bass and Ronald Perelman and giant firms like Ford Motor Company. In all of these deals, the acquirors provided a strikingly small amount of the total capital investment and received

remarkable benefits, ranging from yield maintenance agreements to capital forbearance plans to hazardous waste indemnifications to "pocket charters".

The Federal Home Loan Bank Board (FHLBB) repeatedly insisted that it had struck the best bargains possible with these acquirors. But the Bank Board also insisted on keeping secret its negotiations with each S&L bidder. Members of Congress questioned the validity of deadlines that FHLBB used to pace its assisted acquisitions and challenged the Bank Board's authority to issue tens of billions of dollars in unfunded liabilities without congressional approval.

All these procedural issues lead to a key substantive issue: did the assisted transactions create any incentives for the new owners to manage their thrifts more responsibly than the previous owners? If not, the Bank Board's 1986 deals may only have set the stage for a second round of even more expensive insolvencies and bailouts.

In our view, the questions surrounding FSLIC's 1986 assisted acquisitions are serious enough--and the constitutional grounds solid enough--to warrant renegotiation of these multibillion dollar deals. Compelling the acquirors to accept terms more favorable to the public--e.g. diminished tax benefits, lower-yielding notes, expanded private capital infusions, fewer safety and soundness waivers--would significantly reduce one large component on the total bailout pricetag. It would also clearly signal an end to this episode of mammoth government giveaways.

In conclusion, we would again like to thank Chairman Rostenkowski and other members of the Ways and Means Committee for seeking our views on this important topic. ACORN, and the Financial Democracy Project, would like to work with the Committee to help implement the proposals presented here.

Mr. STARK. Mr. Paterson, welcome to the committee. We have your prepared statement, proceed in any manner. I have to tell you that you have stolen my idea, but go ahead.

**STATEMENT OF CHRISTOPHER A. PATERSON, ROCKVILLE,
MARYLAND**

Mr. PATERSON. Congressman, thank you very much for inviting me here. I would like to quickly add that they say great minds think alike.

Mr. STARK. Thank you.

Mr. PATERSON. I will express my appreciation for the opportunity to address the Ways and Means Committee and to present my observations and suggestions regarding the savings and loan bail-out crisis.

I am a businessman, mainly involved in real-estate-related fields. Over the years, it has been necessary for me to meet payrolls, pay expenses, and make an adequate living for myself and my family. For over 10 years, I have seen the liquidity in much of the savings and loan industry deteriorate, caused in many cases by very poor lending practices along with a do-nothing Government regulatory agency seemingly controlled, or paralyzed at least, by the savings and loan lobbying organizations. To blame falling energy and farm land prices, et cetera, for the current problems might be convenient. However, they were only the proverbial straws that broke a very sick and overloaded camel's back.

Like many other problems, the savings and loan problem have been ignored and swept under the rug until we ran out of rug. The proposal to tax the remaining solvent institutions will have the effect of making them even less competitive in the marketplace. If this country is not to remain forever dependent on the savings of foreigners to finance our deficits, we should earnestly start now to encourage the American people to save and our children to learn the value of thrift to prepare them in case some of them like yourselves choose to serve the people in Government.

My two children do not have savings account because the fees charged for opening and maintaining the savings account would eliminate the principal. I suggest a Youth's Savings Plan which would pay a fair rate of return, perhaps linked to Government bonds. Interest earnings would not be taxed. Youth savings laying around now in their dressers and drawers throughout the Nation are not being taxed now. And more importantly, these savings are not being utilized to teach the value of saving plus helping make this country prosper. I believe that the U.S. Post Office could act as an implementation of this savings program.

As for obtaining the moneys to repay the General Treasury, the billions of dollars used for the savings and loan bail-out, I would suggest the following: enacting a 1 percent Federal excise tax on all commercial and residential property at the time of sale and transfer. This would be collected at the time of settlement/closing, and forwarded to the Treasury at the time of disbursement.

I feel that this tax should be borne by the seller for two reasons. The seller with all probability has utilized some savings and loan over the years, whereas the purchaser may never have been in-

volved in real estate before. The seller also has had inflationary influences working for the enhancement of the dollar of gain being reflected in the sale price of the property being sold. Obviously, this tax would not apply to those elderly persons selling their final residence in compliance with Internal Revenue Service stipulations.

Because of the time consideration, I have been able to assemble total dollar sale value of only three representative States. They are: New York, \$36,548,373,722; Virginia, \$54,413,474,000; Maryland, \$15,598,138,400. In 1988, these three States had real estate sales totaling \$106.5 billion. I believe if all the States were included the figure obtained for the Treasury by this excise tax would be considerable. It would also be collecting this excise tax from an industry more responsible for the problem than persons not in any way involved in real estate.

I very much thank you for your time.

Mr. STARK. Thank you very much, Mr. Paterson. Actually, your idea is one the committee has discussed in the past. As you may recall, Speaker Wright had suggested a transfer tax on securities.

Most real estate investors who are well counseled never do pay any income tax, certainly not any capital gains tax. If they trade and if they pass the property along and get a stepped up basis in their estate, why, real estate seems to go on forever never getting taxed.

On the other hand, real estate investors, never mind, they will pay 6 percent to a broker and 1 percent to the title company and a half a percent to the mortgage broker and that doesn't bother them. So I think what you are suggesting is why not let Uncle Sam get—forget about capital gains. Take real estate out of the capital gains tax for all I care, because we don't collect any anyway, and just charge a half a point or a point every time there is a transfer.

I think we have talked a couple of billion dollars a year would be the revenue out of it, and it would be very useful.

And the other witnesses on the panel have suggested ideas which the chair has found attractive over the years, with one exception, and it will shock most of you to learn that, as a former banker and as once a member of the Banking Committee, I happened to think that red-lining is important. It should be encouraged by the Federal Government for one reason.

All banks and all savings and loans do it, and it is impossible to detect, really, and to enforce anti-redlining. Secondly, I am not sure it is the right thing to do because banks don't make money lending to poor people, and they can't. A bank needs to get income and money from people who have a lot of it.

And so the Stark proposal is to tell the banks and savings and loans they can red line. Tell us where you don't want to lend or provide services, and define it. Say we will take the Southeast section of Washington and red line it. I would say fine. Just so we know what the rules are.

Then, however, don't complain, bank or savings and loan, when the Federal Government encourages low-income credit unions who we would subsidize who could take the additional risks of dealing with people who because of lack of money haven't learned good

thrift habits and credit habits. They never had enough money to plan.

People's whose income comes from part-time occasional work, so they don't have a credit report at the credit rating bureau to say they have had a job. They may have worked every day in their life, but for sometimes as many as 10 employers in a month and paid in cash, so there isn't a record.

And these employees may have sent their children to school well dressed, well trained, yet not able to qualify. A low-income credit union made up of people in a neighborhood who understand either the ethnic patterns or the habits of poor people or in the case of now refugees coming to this country once again for whatever reason are probably far better qualified to decide who is worthy of credit and help train.

And I tell the banks and savings and loan let us do that and we will train these people to be good customers for the bank that deals with rich people.

Seriously, they do red line. I know it. I could tell you how it is done, but I can't find a way to get the law. And I can't make the bank lend anyway. If they don't want to lend to the poor person, there is no way to get them to do that.

So I am saying, fine. Let us know then what area you don't want to serve, and let us find a way to provide subsidized service to these people who cannot exist in modern society without it. So think about that.

As long as you complain about red-lining, they are going to hide it, and you will never be able to solve the basic problem of people who have to participate in a system to understand how to be good participants. And the only way he will take the people without a lot of money, the children who have only pennies to save, the poor person, the person who collects money in cash, which may be illegal but there is a conspiracy in the world that we all understand where people are paid in cash and don't report, therefore they have no credit history, therefore they can't get a loan or a credit card, therefore they have trouble cashing their checks, so they don't have a checking account, and they are subject to being robbed because they carry more cash. It goes on and on and on and on.

The way to stop that is recognize that it goes on and find a way to solve it. And I hope that as you go back to your organizations you will think about that Stark proposal, as far out as it may seem, and say let's do it. It's fine, but let's make the credit unions earn their tax exemption. Let's make the credit unions who are getting a bargain say, OK, what does it take to make a loan to a poor person without a credit history? Patience. That is all it takes.

It is difficult the first time to explain to someone the importance of making a payment on a timely basis and why it is important to a credit rating. And that just takes a little understanding. And banks don't do that. They are not paid to do it. They are trying to crank you through. They will give you a computerized credit check and if you aren't in that computer God help you.

So, as I say, it is a little bit different but I don't think we will ever get decent supervision of red-lining, therefore let's let it go on. But let's find a way to solve the problem if it will be effective to provide access to credit, access to housing, access to the functions

in a cash society that poor people have as much a need and have every right to have as anybody else.

Mr. Coyne.

Mr. COYNE. Ms. Meier, you indicated that we might want to look at some more equitable way to deal with the mortgage interest deduction and to revise what the guidelines are at the present. Do you have specific recommendations about that?

Ms. MEIER. Yes, we have specific proposals. There are a number of others, I am sure, that are worthy of consideration. One though would be to adjust the present indebtedness cap on which interest can be deducted. As you know, right now indebtedness of up to \$1 million is eligible. You could go out and buy \$1 million estate and all the interest on it is tax deductible. That seems very unfair to us.

If you lowered it to approximately \$200,000, we could generate over 5 years, according to CBO estimates, \$10 billion. A \$200,000 home is a pretty nice home. We would still be protecting the middle class homeowner and even the upper middle class homeowner if we lower the deduction to that amount.

We also have the suggestion that the committee consider including the second home and deductions on the interest paid for the second home within the \$100,000 limit on home equity loan borrowing. That is presently a part of the Tax Code.

Mr. COYNE. OK. I just wondered if you did have specific recommendations and that is included in your testimony. Thank you.

I thank the panel for all your testimony, and the meeting is adjourned.

[Whereupon, at 1 p.m., the committee was adjourned, subject to the call of the Chair.]

BUDGET IMPLICATIONS AND CURRENT TAX RULES RELATING TO TROUBLED SAVINGS AND LOAN INSTITUTIONS

WEDNESDAY, MARCH 15, 1989.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[NOTE: Due to a scheduling problem, Secretary of the Treasury Nicholas F. Brady was unable to attend the hearings as scheduled on the subject of the troubled savings and loan institutions. The following testimony was presented at a hearing entitled "The Budget Deficit, the State of the U.S. Economy, and Federal Budget Policy for Fiscal Year 1990 and Beyond." The testimony is being printed in both hearings.]

Chairman ROSTENKOWSKI. The committee will come to order.

Today the Ways and Means Committee continues its hearings on several topics.

First, this morning we will receive testimony from Nicholas Brady, the Secretary of the Treasury. Mr. Brady will discuss the President's proposed fiscal year 1990 budget. In addition, Mr. Brady will testify regarding the administration's proposal to assist trouble savings and loan institutions.

With respect to the President's budget, I am disappointed that the administration continues to use unrealistic economic assumptions, and that the capital gains tax rate reduction proposals have been put on the table. I believe deficit reduction is our highest domestic priority. As I have said many times, deficit reduction is going to require a balanced package of tax increases and spending reductions.

In addition, this committee has conducted several hearings regarding the budget implications and current tax rules relating to troubled savings and loan institutions. We heard disturbing testimony regarding the use of those special rules in transactions closed in December of 1988 by the Federal Home Loan Bank Board.

In addition, we received many comments regarding the administration's proposal to assist troubled savings and loan institutions. Several witnesses expressed concern over certain aspects of the proposal, including the off-budget treatment of payments of principal on bonds to fund the assistance plan, and that the potential costs of the assistance will far exceed current estimates.

This committee has jurisdictional concerns regarding the administration's proposal, including issues concerning revenues and debt management. In order to pinpoint those concerns, I have sent a letter to Secretary Brady with a list of questions regarding the administration's proposal. A copy of that letter has been made available to all members, and I would like to include a copy in the record. It is my understanding that Secretary Brady will respond to that letter tomorrow in a separate submission to be included as part of this record.

[The letter and response follow:]

ONE HUNDRED FIRST CONGRESS
 DAN ROSTENBOWSKI, ILLINOIS, CHAIRMAN
 SAM M. GIBSON, FLORIDA
 J.J. PICKLE, TEXAS
 CHARLES E. RANGEL, NEW YORK
 FORTNEY PETE STARR, CALIFORNIA
 ANDY JACOBS, JR., BRIDGEMAN
 HAROLD FORD, TENNESSEE
 ED JENKINS, GEORGIA
 RICHARD A. GEPHARDT, MISSOURI
 THOMAS J. DOWNNEY, NEW YORK
 FRANK J. GUARINI, NEW JERSEY
 MARTY RUSCO, ILLINOIS
 DON J. PEASE, OHIO
 ROBERT T. MATSUI, CALIFORNIA
 BERYL ANTHONY, JR., ARKANSAS
 ROHNE G. RUPPO, ALABAMA
 BYRON L. DORGAN, NORTH DAKOTA
 BARBARA S. KENNELLY, CONNECTICUT
 BRIAN J. DONNELLY, MASSACHUSETTS
 WILLIAM J. COYNE, PENNSYLVANIA
 MICHAEL A. ANDREWS, TEXAS
 SANDER M. LEVIN, MICHIGAN
 JIM MOODY, WISCONSIN

ELL ARCHER, TEXAS
 GUY VANDER JAET, MICHIGAN
 PHILIP M. CRANE, ILLINOIS
 BILL FRENDEL, MINNESOTA
 JACK SCHULZE, PENNSYLVANIA
 BILL BRIDGES, OHIO
 WILLIAM H. THOMAS, CALIFORNIA
 RICHARD J. RUBINATH, NEW YORK
 MARK BROOKS, COLORADO
 BOB CHAMBERLAIN, WASHINGTON
 S. CLAY BARNES, JR., FLORIDA
 BEN BURROUGHS, TENNESSEE
 TERRY L. JARMAN, CONNECTICUT

ROBERT J. LEONARD, CHIEF COUNSEL AND STAFF DIRECTOR

PHILIP E. MORELEY, MINORITY CHIEF OF STAFF

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES
 WASHINGTON, DC 20515

February 23, 1989

The Honorable Nicholas F. Brady
 Secretary of the Treasury
 U.S. Department of the Treasury
 1500 Pennsylvania Avenue, N.W.
 Room 3330
 Washington, D.C. 20220

Dear Secretary Brady:

As you know, you are scheduled to testify on March 9 as part of the Committee on Ways and Means' hearings on the budget implications and current tax rules regarding troubled savings and loan institutions, as well as the President's fiscal year 1990 budget. I am very pleased that you will have the opportunity to present the Administration's proposals to the Committee.

In order to facilitate your testimony and the Committee's review of the savings and loan institution issues, I request that your testimony address the following questions. I understand that the Administration's specific legislative proposals to assist troubled savings and loan institutions were introduced in the Senate yesterday, however, I have not had the opportunity to review them. Thus, it would be of great assistance to this Committee if you would address the following questions which relate to the Committee's jurisdiction over issues involving revenues and management of the debt.

1. Does the Administration's proposal to assist troubled savings and loan institutions (hereafter "Proposal") provide for a legal commitment of the Federal government to pay the principal or interest on any bonds issued by the Resolution Financing Corporation (REFCORP)?
2. Does the Proposal contemplate an indirect or moral obligation of the Federal government to pay, or otherwise financially indemnify, the payment of principal or interest on bonds issued by REFCORP? In this regard, what representations will be made to potential purchasers of these bonds?

The Honorable Nicholas F. Brady
February 23, 1989
Page Two

3. Under the Proposal, do you anticipate that the Resolution Trust Corporation (RTC) will have the ability to require institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) or the Federal Deposit Insurance Corporation (FDIC) to pay increased premiums or other assessments? If so, to what extent is the RTC anticipated to exercise this authority?
4. What is the total amount of premium payments you anticipate being paid by institutions insured by the FSLIC during the first five years after the implementation of the Proposal?
 - (a) How much of this amount is a result of increasing the premium payments required of institutions insured by the FSLIC under the Proposal?
 - (b) What is the total amount you anticipate will be expended from the FSLIC insurance fund during the first five years after implementation of the Proposal?
 - (c) For what purposes will these amounts be expended?
 - (d) What is the total amount you anticipate to be available in the FSLIC insurance fund at a time five years after the implementation of the Proposal? Please provide an estimate of the ratio of insurance fund reserves to insured deposits after that five year period.
5. With respect to question 4, please provide the same information with respect to institutions insured by the FDIC and the FDIC insurance fund.
6. If the RTC does exercise its authority as discussed in question 3, please provide, if applicable, the same information requested in question 4 with respect to premium payments and assessments made by the RTC.
7. What other sources of funds, besides those which may be specified in questions 4-6, will be used to make interest payments on REFCORP bonds?
8. What will be the sources of funds to be used by REFCORP to purchase the zero coupon Treasury securities under the Proposal?
9. Do you anticipate that through legislation, ruling, or informal administrative activity, REFCORP will be considered exempt from Federal taxation?

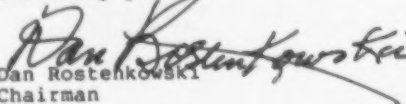
The Nicholas F. Brady
February 23, 1989
Page Three

10. With respect to question 9, please specify the anticipated tax treatment to REFCORP resulting from its holding of zero coupon Treasury securities under the Proposal.
11. Please specify whether the Financing Corporation (FICO) established by the Competitive Equality Banking Act of 1987 is treated as an entity exempt from Federal taxation.
12. Please describe the anticipated tax treatment of the bonds to be issued by REFCORP.
13. Under the Proposal, how are funds raised by REFCORP paid to troubled thrift institutions?
14. Does the Administration propose and support an extension of the special tax rules for troubled thrifts and banks, currently expiring on December 31, 1989? Why are these expiring provisions important in providing assistance to troubled institutions? If so, will such an extension be included as part of the Proposal? What would be the revenue effect of any proposed extension, and how should any revenue loss be paid for?

I want to emphasize, Mr. Secretary, my position that if the Administration supports extension of these expiring tax provisions, such a proposed extension should be included in the Administration's official savings and loan proposal rather than in separate legislation later in the year that may or may not materialize.

I look forward to receiving your testimony on March 9, and to working with you as a resolution of this issue is formulated. Thank you for your attention to this request.

Sincerely yours,


Dan Rostenkowski
Chairman



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

March 16, 1989

Dear Mr. Chairman:

Enclosed please find the Department of the Treasury's response to questions on savings and loan institutions issues as requested by the Committee on Ways and Means in your letter of February 23, 1989.

Sincerely,

John K. Meagher
Assistant Secretary
(Legislative Affairs)

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, DC 20515

Enclosure

cc: The Honorable Bill Archer

Question #1:

Does the Administration's proposal to assist troubled savings and loan institutions provide for a legal commitment of the Federal Government to pay the principal or interest on any bonds issued by REFCORP?

Answer:

- o The principal of all REFCORP bonds would be paid entirely by the S&L industry itself. No Treasury funds or guarantees are involved in any way.
 - FHLBank retained earnings and profits, S&L premiums, and the proceeds from old FSLIC receiverships would be used to purchase zero coupon Treasury securities.
 - At maturity, the zeroes would be used to pay off the principal of the REFCORP bonds.
- o The interest on REFCORP bonds would be paid by the S&L industry with the Treasury making up any shortfall.
 - Contributions from FHLBank profits, the Resolution Trust Corporation's proceeds from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions will be contributed from the industry.

Question #2:

Does the Proposal contemplate an indirect or moral obligation of the Federal government to pay, or otherwise financially indemnify, the payment of principal or interest on bonds issued by REFCORP? In this regard, what representations will be made to potential purchasers of these bonds?

Answer:

- o There are no hidden Federal government obligations in this plan whatsoever.
 - The \$50 billion principal on the bonds will be guaranteed by zero-coupon Treasury bonds purchased by the industry itself. There is no set of circumstances under which Treasury funds would be used to pay any of the REFCORP bond principal.
 - The U.S. Treasury will make the interest payments on the REFCORP bonds, but will pay only the shortfall after industry contributions to interest payments are exhausted.

- o By being as forthcoming as possible with our legislative proposal and Congressional testimony, we believe that we have already made this representation to potential purchasers of these bonds.

Question #3:

Under the Proposal, do you anticipate that the RTC will have the ability to require institutions insured by the FSLIC or the FDIC to pay increased premiums or other assessments? If so, to what extent is the RTC anticipated to exercise this authority?

Answer:

- o The RTC has no authority to assess institutions and is funded entirely from the proceeds of REFCORP bond issues.
- o The Resolution Funding Corporation (REFCORP), with the approval of the Board of Directors of the FDIC, may use insurance assessments to fund zero coupon Treasury securities only if the FHLBank contributions are exhausted.
- The amount of these assessments (plus FICO assessments) is subtracted from the amount the FDIC is authorized to assess insured savings associations.
- Thus, the authorized assessment limit for the FDIC is an absolute limit. REFCORP has no power to override this limit.

Question #4:

What is the total amount of premium payments you anticipate being paid by institutions insured by the FSLIC during the first five years after the implementation of the Proposal?

Answer:

- o Between 1989 and 1993, FSLIC-insured institutions will pay \$13.1 billion in insurance premiums.
- Of this amount, \$.9 billion will be the result of our proposed 2.2 basis point increase in the insurance premium in 1991, 1992, and 1993. The premium will decrease by 5 basis points in 1994.
- o All of the funds collected in insurance premiums will be expended.

- About \$1 billion per year will be required to cover the interest on the \$10.8 billion in FICO bonds.
- The remaining premium income in 1990 and 1991 will be used to fund the REFCORP principal and the FSLIC Resolution Fund (for old FSLIC assets and liabilities).
- Beginning in 1992, premiums go first to service FICO interest and then to build up the Savings Association Insurance Fund (SAIF).
- o We anticipate that in 1993 the SAIF could have as much as \$8 billion in it, depending on the amount needed to resolve insolvent institutions after the RTC has closed the 500 institutions that are either GAAP insolvent or nearly GAAP insolvent.
- In any case, under our plan, the Treasury would guarantee that at a minimum the SAIF would have \$2.1 billion in it by 1993.

Question #5:

With respect to question 4, please provide the same information with respect to institutions insured by the FDIC and the FDIC insurance fund.

Answer:

- o Between 1989 and 1993, banks will pay \$15.8 billion in insurance premiums.
- Of this amount, \$5.9 billion will be the result of our proposal for increased premiums.
- o No bank premium funds will be spent on FSLIC-insured institutions.
- We have recommended this premium increase to bring the bank insurance fund back up to its historical level.
- The bank fund is currently at \$14 billion, which is .83% of insured deposits. We expect it to reach 1.25% sometime after 1999.

Question #6:

If the RTC does exercise its authority as discussed in question 3, please provide, if applicable, the same information requested in question 4 with respect to

premium payments and assessments made by the RTC.

Answer: (see question #4)

- o Our plan assumes that REFCORP may require some premium income to fund the REFCORP principal.
- Before the use of premium income, \$2.7 billion in FHLBank retained earnings and profits will fund REFCORP principal from 1989 to 1991.
- If interest rates are consistent with OMB assumptions, \$1.7 billion of premium income will be required for this purpose in both 1990 and 1991. If interest rates are higher, a smaller amount of premium income will be required.
- Again, neither RTC nor REFCORP has any authority to increase premiums above the FDIC assessments.

Question #7:

What other sources of funds, besides those which may be specified in questions 4-6, will be used to make interest payments on REFCORP bonds?

Answer:

- o No S&L insurance premiums will go towards the payment of interest on REFCORP bonds. However, other sources of industry funds will be used towards interest payments.
- Proceeds from the sale of new receivership assets, proceeds from warrants and equity participation taken in resolutions, and \$300 million per year in FHLBank profits will be contributed from the industry, and proceeds of all net assets of the RTC upon its dissolution.
- Treasury funds will make up any shortfall in interest payments.

Question #8:

What will be the sources of funds to be used by REFCORP to purchase the zero coupon Treasury securities under the Proposal?

Answer:

- o No Treasury funds or guarantees will be used to repay any REFCORP principal.

- o All funds for repaying REFCORP principal will come from the industry itself.
- FHLBank retained earnings, and as required, S&L premiums and proceeds from the sale of old FSLIC receivership assets will fund the principal.

Question #9:

Do you anticipate that through legislation, ruling, or informal administrative activity, REFCORP will be considered exempt from Federal taxation?

Answer:

- o In our proposal, REFCORP would be tax exempt in the same way that the Federal Home Loan Banks and FSLIC's Financing Corporation (FICO) are. FICO is owned by the FHLBanks, just as REFCORP would be.

Question #10:

With respect to question 9, please specify the anticipated tax treatment to REFCORP resulting from its holding of zero coupon Treasury securities under the Proposal.

Answer:

- o In the Administration proposal, the zero coupon Treasury securities would be treated just as those held by FICO, which are tax exempt.
- o If this were not the case, any funding proposal would have to be more expensive.
- In fact, the effect would be felt in the first three years of our proposal, because more zeros would have to be purchased up front to fund the \$50 billion in principal.

Question #11:

Please specify whether the FICO established by the Competitive Equality Banking Act of 1987 is treated as an entity exempt from Federal taxation.

Answer:

- o Yes, the FICO established by the Competitive Equality Banking Act of 1987 is tax-exempt. It is treated just as its owners, the Federal Home Loan Banks, are treated.

Question #12:

Please describe the anticipated tax treatment of the bonds to be issued by REFCORP.

Answer:

- o The Administration proposal would provide that the obligations of the REFCORP would have the same tax status as obligations of the FHLBanks. This is also true of FICO obligations.
- Thus, interest earned on these obligations would be taxable as income at the federal, but not the State level.
- Treating REFCORP and FICO obligations in the same manner as FHLBank obligations is derived from the fact that the FHLBanks are the owners of FICO and the proposed owners of REFCORP.

Question #13:

Under the Proposal, how are funds raised by REFCORP paid to troubled thrift institutions?

Answer:

- o Funds raised by REFCORP would be provided to the Resolution Trust Corporation (RTC), in exchange for capital certificates in an equal amount.
- o The RTC is authorized to enter into a contract with the FDIC (as primary manager), and any other entity to manage insolvent institutions.
 - Management of these institutions might involve placing them in receiverships, liquidating conservatorships, engaging in assisted mergers, or liquidations.
 - The RTC Oversight Board would consider all relevant proposals, including innovative new approaches forthcoming from public agencies and the private sector, in overseeing the RTC's resolution activities.
- o The RTC Oversight Board, consisting of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Attorney General, is charged with general oversight of the strategy and execution of the resolution process. This involves determining resolution strategy and reviewing and approving

resolutions.

Question #14:

Does the Administration propose and support an extension of the special tax rules for troubled thrifts and banks, currently expiring on December 31, 1989? Why are these expiring provisions important in providing assistance to troubled institutions? If so, will such an extension be included as part of the Proposal? What would be the revenue effect of any proposed extension, and how should any revenue loss be paid for?

Answer:

- o The Administration plan does not include an extension of the special tax rules. We expect them to expire after December 31, 1989.
- o These provisions were important to FSLIC resolutions quite simply because FSLIC did not have adequate resources to use cash to deal with the hundreds of insolvent thrifts.
- o Our plan, however, provides what we believe will be more than enough funds up front to resolve all currently GAAP insolvent institutions, as well as any others that may become insolvent.
- As a result, we do not anticipate that the RTC will need to use any special tax benefits.

Chairman ROSTENKOWSKI. As I have stated before, it is certainly not my intention to delay the consideration of this important proposal. It is my hope that when this committee considers this legislation after the Banking Committee has acted, we will consider the appropriateness, including the cost effectiveness, of measures within our jurisdiction.

Today the committee will also continue to receive testimony regarding the tax policy aspects of mergers and acquisitions.

Our first witness is Secretary Brady. Good morning, Mr. Secretary. I am pleased that you can join us, but before you begin, I would like to yield to my colleague, Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman, and thank you, Secretary Brady, for making yourself available to us this morning.

As we begin the third day of our committee's hearings on the budget and tax implications of the current situation in the thrift industry, I want to emphasize my view that it is essential that the Congress and the administration take action on the thrift problem as soon as possible.

I am very concerned by reports that indicate that each additional day that we wait costs us \$40 million.

We are all grateful to President Bush for sending to the Congress a solution to the thrift problem within less than 3 weeks of taking office. The enormity of the President's task and Secretary Brady's task cannot be overstated. While the administration proposal may be changed in a number of ways before it is enacted, it provides a broad framework to guide the Congress in its deliberations.

The Bush proposal has brought much needed reassurance to depositors throughout the Nation, that their hard-earned deposits are protected. That is a point that we in Congress need to constantly emphasize in our public and private statements. We cannot let the message that deposits are protected get lost in the congressional debate over individual points in the proposal.

I believe that the other members of this committee share my desire to expedite any necessary action within the committee's jurisdiction, and I look forward to your testimony, Secretary Brady.

Chairman ROSTENKOWSKI. It is a pleasure, Mr. Secretary, to have you with us this morning. If you are ready, you may begin.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY OF THE TREASURY, ACCOMPANIED BY DENNIS ROSS, ASSISTANT SECRETARY FOR TAX AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman, and as you mentioned, you asked the Department a detailed—to submit a detailed list of questions, and we are in the process of supplying the answers to those questions, and they should be up here today if they are not here already. So, that procedure is all right with you.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

Secretary BRADY. A good part of my testimony you have heard before, Mr. Chairman, so I have picked parts of it out, and if it seems a little disjointed, it is just that I will not reread stuff that you have already heard before.

I am pleased to be here with you to discuss President Bush's proposed fiscal year 1990 budget and related items. I know you have already heard from the Office of Management and Budget Director, Dick Darman, so in my testimony, I will not repeat a detailed presentation of the Bush budget.

The approach to the budget I wish to take today is from the perspective of overall economic policy. Thus, I will discuss the importance of deficit reduction to the continued vitality and strength of our national economy and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion. At the same time, we are also aware that the Federal Reserve recently raised the discount rate one-half of 1 percent, to 7 percent. I would like to say a few words about that.

First and foremost, the administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. It is possible, however, to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapon in its arsenal to fight inflation to advance the cause of the long-term strength and vitality of the economy. The strongest weapon we in the Government have, both the executive and the legislative, to further the cause of our long-term economic strength, is to act on deficit reduction. I am sure you agree, we all must do our part.

The Bush administration is absolutely committed to working with you to reduce the deficit. Some have questioned our economic assumptions, but I would like to point out that historically, the executive branch's assumptions have not had a consistent bias toward a rosy scenario. In fact, in the last 7 years the administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted rate. We are projecting that GNP will grow 3.5 percent next year, but when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8 percent growth rate. This is lower than last year's 3.4 percent drought adjusted growth rate, and our long-term forecast for a 3.2 percent sustainable growth rate is right in line with our experience over the past 40 years, during which real GNP averaged 3.3 percent.

As one who worked for over 30 years in the financial markets, I would like to make a few comments on interest rate assumptions. During my first year in business, 1954, 10-year Government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same 10-year Government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986, and they now carry an interest rate of about 9.3 percent.

I attach an exhibit which you may have seen before, but it shows a graph showing the decline in interest rates surrounding the passage of Gramm-Rudman. From 3½ months prior to the passage of this important fiscal legislation until 3½ months after, interest rates declined 300 basis points.

Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes, I believe so.

This would indicate to me that while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have a direct effect on these rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our Government that we are committed to fiscal prudence and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high level of interest rates and cost the United States and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we do not reduce the deficit? No, I do not. Will they prove accurate if we do? Yes, I believe so.

I know that you have heard a great deal about the specific proposals in the budget from Director Darman. I would simply like to reiterate the fundamental point that within the confines of meeting the Gramm-Rudman, the President has proposed budget priorities, which if adopted, will make a significant investment in the country's future.

A few words about the savings and loan solution.

President Bush's budget contains the funding required to resolve the savings and loan crisis. It has three components. The first part consists of \$50 billion to resolve currently insolvent institutions and those which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the \$40 billion in past FSLIC obligations. And third, and perhaps the most important, the plan provides \$33 billion in financial resources necessary to put the S&L deposit insurance fund on a sound financial basis for the future.

At the heart of the plan is the creation of the Resolution Trust Company, so-called "RTC," for which the FDIC will be the primary manager, directed to resolve all S&L's which are now insolvent or become so over the next 3 years.

To provide the \$50 billion to the RTC, we will create a new, separate, privately-owned corporation—the Resolution Funding Corporation, so-called "REFCORP"—which will issue \$50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of \$50 billion, the same amount of the REFCORP principal bonds. This assures the repayment of the principal bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources.

The Federal Home Loan Banks will contribute about \$2 billion of their retained earnings, which are currently allocated to, but not needed by, the existing Financing Corporation—FICO—plus approximately 20 percent of their annual earnings, or \$300 million in 1989, 1990, and 1991. The S&L's will contribute a portion of their insurance premiums, and, if necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal. Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources.

The Federal Home Loan Banks, beginning in 1992, will contribute \$300 million per year. The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations in resolutions, and, if necessary, Treasury funds will make up any shortfall.

All Treasury funds planned to be used to service REFCORP interests will be scored for budget purposes in the year expended.

Funds for the second component of our plan, servicing the cost of \$40 billion in resolutions already completed by FSLIC, also will come from a combination of S&L industry and taxpayer sources.

FICA will issue bonds under its remaining authority and contribute the proceeds. The S&L's will contribute a portion of their insurance premiums. FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income, and, again, Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies, and building the savings association insurance fund, so-called SAIF, the new S&L insurance fund during the post-war period.

The funding will come from a portion of S&L insurance premiums and Treasury funds, as needed. These sources provide about \$3 billion per year to handle any insolvencies which occur in the 1992-99 period, and, in addition, contribute at least \$1 billion per year to the building of the new savings association insurance fund.

Overall, the plan contains \$33 billion in post-RTC funds from 1992 to 1999, to manage future insolvencies, and contribute to building a healthy new S&L insurance fund. Assuming that \$24 billion is used for post-RTC resolutions, by 1999, the SAIF fund will still contain just under \$9 billion, at a minimum, to support the healthy S&L's.

The net impact of the entire plan, which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be completed, and providing for fully funded insurance funds for both commercial banks and thrifts, is \$1.9 billion in fiscal year 1990, and \$39.9 billion over the next 10 years.

The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

First of all, we propose a major tax initiative designed to enhance America's long-term growth and competitiveness, and a reduction in restructuring of the capital gains tax to encourage long-term investment.

Our proposal calls for a 45 percent exclusion of long-term gains, or a 15 percent tax rate cap, whichever benefits the taxpayer the most. As an important part of this plan we have targeted the greatest relative benefits to those with incomes lower than \$20,000, if married, and \$10,000, if single.

Such taxpayers would be eligible for 100 percent exclusion, and no tax at all on the long-term gains. The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921 and remained in effect for 65 years.

The Tax Reform Act of 1986 eliminated that differential in 1987, while generally reducing taxes. In our view, the reinstatement of some type of capital gains differential is consistent with one of the major goals of the 1986 act. That was, and is, to reduce tax rates to stimulate entrepreneurial activity. Our proposal does that by targeting the benefit of those activities which will expand economic productivity and expand investment.

I believe the essential benefit of a reduction of capital gains tax goes beyond simply encouraging short-term investment and growth. Over the next 4 years, we propose to phase in a 3-year holding period for capital assets sold to qualify for the lower capital gains tax rates.

Thus, we want to shift the focus of investors from short-term to the long-term because, ultimately, it is our long-term investment which will provide our economy with its fundamental strength. Thus, we propose to restore this incentive to the American enterprise system.

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is going to remain a leader in the world economy.

It is equally important that we take steps to augment policies and programs which stimulate research and development, and which foster our long-term productive capacity. To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the enacted 1989 funding levels.

Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation by U.S. industry.

The current credit expires at the end of 1989. We feel it is time to stop sending stop-and-go signals to the business community on the importance of research to our economic strength.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape, so that U.S. corporations can make their research and experimentation plans for the longer horizon.

With this same purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

In order to stimulate local Government and private-sector revitalization of economically distressed areas, the President has proposed an enterprize zone initiative.

This initiative includes selective Federal employment and investment tax credits to be offered in conjunction with Federal, State, and local regulatory relief. Up to 70 zones may be selected between 1990 and 1993.

Mindful of the growing need for child care, the President proposes to increase assistance to low-income families through changes in the Tax Code. He proposes a new refundable tax credit of up to \$1,000 for each child under 4 in low-income working families.

This credit would be available to very low-income families in which at least one parent works in the tax year 1990, and will be expanded to include additional families in following years.

By this tax assistance the President's budget provides vital support to families while permitting them to make their own choices about child care that best fits their needs.

The President further proposes to make the existing dependent care credit refundable. In its current state, the existing credit is of no value to low-income families who do not pay a tax.

The President also proposes to permit the deduction from income of expenses incurred associated with the adoption of special needs children, up to a maximum of \$3,000 per child.

Currently, State and local employees hired prior to April 1986 are not covered by Medicare hospital insurance, nor are they subject to the tax. The President's budget proposes that as of October 1, 1989, all State and local Government employees would be covered by Medicare hospital insurance.

These are the major revenue-related proposals in the President's budget.

Let me say a few words about the international context of our discussions. Improving our competitive position in the world economy is very important to our future international economic position.

Reducing the deficit will not only improve our competitive position but is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work on the budget this year.

The new reality is that there are no more international boundaries when it comes to the flow of dollars. No border control, no Customs officials, and no barriers. The influence of foreign financial markets on our economy is great indeed.

Most of the world's dollar financial transactions settle daily through New York. Before the advent of instantaneous transfer of information and electronic funds transfer, this settling of accounts would have taken several weeks, if not months. Now it occurs every night.

There are two wires that go through the New York Fed where transactions settle. The CHIPS wire which largely handles international transactions, and the Fed wire which handles mostly, but not exclusively, domestic transactions.

Last month, on average, about \$735 billion worth of transactions were settled per day on the CHIPS wire, and the level of activity is increasing at the rate of 25 percent a year.

If you approximate the international transactions settled via the Fed wire, then about \$1 trillion of international transactions are settled every day and every night through these systems. This amounts to \$5 trillion a week. In other words, greater each week than our yearly GNP.

Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987, the recorded stock of U.S. assets held by foreigners was about \$400 billion greater than the stock of foreign assets held by Americans.

While one can have different views of how to interpret these numbers, one point is clear. We cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the two Fed wires, and the amount of U.S. assets held by foreigners are, in a

sense, a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget deficit.

The tally of the world's opinion of our progress is registered every day at the New York Fed. It is vital that we act decisively to preserve that confidence.

Lest there be any doubt about the extent of the world's interests and concern about the deficit, let me share with you some of the feelings that the G-7 has, who met here in Washington just a few weeks ago on our economy, and what we are doing about the deficit. In the G-7 we are engaged in a team effort, the economic policy coordination process to provide a growing world economy.

For our part, I have been pressing our foreign colleagues to stimulate their domestic economies and open their markets to sustain world growth. They, in turn, are deeply concerned about our ability to reduce the deficit. They worry that we lack the strength of purpose to meet the Gramm-Rudman target.

And they are knowledgeable about the details of our budget process, and are watching very carefully how we handle our budget negotiations.

They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal. That if meeting the \$100 billion target becomes too onerous, that we will simply move the goal line.

I assured them on behalf of all of us, that people in this Government, legislative and executive branches alike, are firmly and absolutely committed to meeting the deficit reduction target. I told them we would get there, one way or the other.

Mr. Chairman, I know you share this commitment, and I am delighted to be here today to discuss with you anything in my testimony, and anything we can do to achieve this common goal.

[The statement of Secretary Brady follows:]

Text as Prepared
 Embargoed For Release Upon Delivery
 Expected at 10:00 a.m., E.S.T.

Testimony by
 Secretary of the Treasury
 Nicholas F. Brady
 Before the
 Committee on Ways and Means
 U.S. House of Representatives
 Wednesday, March 15, 1989

Chairman Rostenkowski, Mr. Archer and members of the Committee, I am pleased to be here today to discuss with you President Bush's proposed fiscal year 1990 budget. I know that you have already heard from the Director of the Office of Management and Budget, Richard Darman, so in my testimony I will not repeat a detailed presentation of the Bush budget.

The approach to the budget I wish to take today is from the perspective of overall economic policy, thus, I will discuss the importance of deficit reduction to the continued vitality and strength of our national economy and to maintaining and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion, which has produced millions of jobs, while reducing inflation. We must equally be aware that to sustain this expansion we must reduce the deficit.

As you know, the Federal Reserve recently raised the discount rate one half of a percent to seven percent. I'd like to say a few words about that. First, and foremost, the Bush Administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. It is possible to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapon in its arsenal to fight inflation to advance the cause of the long-term strength and vitality of our national economy. The strongest weapon we in the government have to further the cause of our long-term economic strength is deficit reduction. We must do our part. Even to delay action costs us -- in terms of interest rates, jobs, the Savings and Loan crisis, the third world debt problem.

Let us be frank with one another. We are constrained between revenue levels that are the result of the 1988 election which validated President Bush's commitment to "No new taxes" and a Gramm-Rudman-Hollings maximum deficit level of \$100 billion prescribed in law. So, there are not funds to do all that we

want.

Stepping back from the roar of the budget discussions for a minute, one could say, "This is where the country wants us to operate." The key is to have the American people say, "They did what we wanted with what we gave them."

ECONOMIC ASSUMPTIONS

The Bush Administration is absolutely committed to working with you to reduce the deficit. Some have questioned our economic assumptions. But, I would like to point out that historically the executive branch's economic assumptions have not had a consistent bias toward a rosy scenario. In fact, in the last seven years, the Reagan Administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted rate. We are projecting that GNP will grow 3.5 percent next year. But when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8 percent growth rate. This is slower than last year's 3.4 percent drought adjusted growth rate. Our long term forecast for a 3.2 percent sustainable growth rate is right in line with our experience over the past 40 years, during which real GNP growth averaged 3.3 percent.

As one who worked for over 30 years in financial markets, I would like to make a few comments on interest rate assumptions. During my first year in business, 1954, ten-year government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same ten-year government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986. They now carry an interest rate of about 9.3 percent.

Attached as an exhibit to my testimony is a graph showing the decline in rates surrounding the passage of Gramm-Rudman-Hollings. From three and one-half months prior to the passage of this all-important fiscal legislation until three and one-half months after, interest rates declined 300 basis points. Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes.

This would indicate to me that while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have an effect on interest rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our government that we are committed to fiscal prudence, and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high

level of interest rates and cost the U.S. and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we don't reduce the deficit? No. Will they prove accurate if we do? I believe so.

I know that you have heard a great deal about the specific proposals in our budget from Budget Director Darman. I would simply like to reiterate the fundamental point that, within the confines of meeting the Gramm-Rudman-Hollings target, the President has proposed budget priorities which if adopted will make a significant investment in our country's future.

THE SAVINGS AND LOAN SOLUTION

The President's budget contains the funding required to resolve the Savings and Loan crisis. It has three components. The first part consists of \$50 billion to resolve currently insolvent institutions and those which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the \$40 billion in past FSLIC obligations.

And third, and perhaps most important, the plan provides \$33 billion in financial resources necessary to put S&L deposit insurance on a sound financial basis for the future.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC), for which the FDIC will be the primary manager, directed to resolve all S&Ls which are now insolvent or become so over the next three years.

To provide the \$50 billion to the RTC, we will create a new, separate, privately-owned corporation, the Resolution Funding Corporation (REFCORP), which will issue \$50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of \$50 billion. This assures the repayment of the principal of the bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources:

- The FHLBanks will contribute about \$2 billion of their retained earnings -- which are currently allocated to, but not needed by, the existing Financing Corporation (FICO) -- plus approximately 20 percent of their annual earnings, or \$300 million, in 1989, 1990 and 1991;
- The S&Ls will contribute a portion of their insurance premiums; and

- If necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources:

- The FHLBanks, beginning in 1992, will contribute \$300 million a year;
- The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions; and
- Treasury funds will make up any shortfall.

All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the cost of the \$40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources:

- FICO will issue bonds under its remaining authority and contribute the proceeds;
- The S&Ls will contribute a portion of their insurance premiums;
- FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income; and
- Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies and building the Savings Association Insurance Fund (SAIF), the new S&L insurance fund, during the post-RTC period. The funding will come from a portion of S&Ls' insurance premiums and Treasury funds as needed.

These sources provide about \$3 billion per year to handle any insolvencies which occur in the 1992-99 period and in addition contribute at least \$1 billion per year to building the new Savings Association Insurance Fund. Overall the plan contains \$33 billion in post-RTC funds from 1992 to 1999 to manage future insolvencies and contribute to building a healthy new S&L insurance fund. Assuming that \$24 billion is used for

post-RTC resolutions, by 1999 the SAIF fund will still contain just under \$9 billion at a minimum to support the healthy S&Ls.

The net impact of the entire plan -- which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be completed, and providing for fully funded insurance funds for both commercial banks and thrifts -- is \$1.9 billion in FY90 and \$39.9 billion over the next 10 years.

REVENUE PROVISIONS

The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

CAPITAL GAINS

We propose a major tax initiative designed to enhance America's long-term growth and competitiveness: a reduction and restructuring of the capital gains tax to encourage long-term investment. Our proposal calls for a 45 percent exclusion of long-term gains or a 15 percent tax rate cap, whichever is more advantageous to the taxpayer. As an important part of this plan, we have targeted the greatest relative benefits to those with incomes lower than \$20,000, if married, and \$10,000 if single. Such taxpayers would be eligible for a 100 percent exclusion--no tax at all on long-term capital gains.

The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921. This policy remained in effect for 65 years. During this time it was endorsed by Democrats and Republicans alike as an important means of stimulating investment. The Tax Reform Act of 1986 eliminated that differential in 1987 while generally reducing taxes. In our view, the reinstatement of some type of capital gains differential is totally consistent with one of the major goals of the 1986 Act. That was, and is, to reduce tax rates to stimulate entrepreneurial activity.

Our proposal does that by targetting the benefits of those activities which will expand economic productivity and expand investment. I believe the essential benefit of a reduction in the capital gains tax goes beyond simply encouraging short-term investment and growth. Over the next four years, we propose to phase in a three-year holding period for capital assets sold to qualify for the lower capital gains tax rates. Thus we want to shift the focus of investors from the short-term to the long-term, because ultimately, it is long-term investment which will provide our economy with its fundamental strength. Thus we propose to restore this long-acknowledged incentive to American

enterprise.

RESEARCH AND EXPERIMENTATION

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is going to remain a leader in the world economy. It is equally important that we take steps to augment policies and programs which stimulate research and development and which foster our long-term productive capacity.

To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the enacted 1989 funding levels. Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation (R&E) by U.S. industry. The current credit expires at the end of 1989. It's time we stopped sending stop and go signals to the business community on the importance of research to our economic strength.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape so that U.S. corporations can make their R&E plans with a longer horizon. With this same purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

ENTERPRISE ZONES

In order to stimulate local government and private sector revitalization of economically distressed areas, the President has proposed an enterprise zone initiative. This initiative includes selected federal employment and investment tax credits to be offered in conjunction with federal, state, and local regulatory relief. Up to 70 zones may be selected between 1990 and 1993.

CHILD CARE

Mindful of the growing need for child care, the President proposes to increase assistance to low-income families through changes in the tax code. He proposes a new, refundable tax credit of up to \$1,000 for each child under four in low-income working families. This credit would be available to very low-income families, in which at least one parent works, in tax year 1990, and will be expanded to include additional families in following years. By this tax assistance the President's budget provides vital support to families while permitting them to make their own choices about child care that best fits their needs. The President further proposes to make the existing dependent care credit refundable. In its current state the existing credit

is of no value to lower income families who do not pay tax.

SPECIAL NEEDS ADOPTION

The President proposes to permit the deduction from income of expenses incurred associated with the adoption of special needs children up to a maximum of \$3,000 per child.

MEDICARE HOSPITAL INSURANCE

Currently, State and local employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance, nor are they subject to the tax. The President's budget proposes that as of October 1, 1989, all state and local government employees would be covered by Medicare Hospital Insurance.

These are the major revenue-related proposals in the President's budget. Let me reiterate that the intent behind these proposals is to sustain a strong economy while fostering an equitable distribution of benefits and responsibilities to our citizens.

INTERNATIONAL CONTEXT

Improving our competitive position in the world economy is very important to our future international economic position. Reducing the deficit will not only improve our competitive position, but is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work on the budget this year.

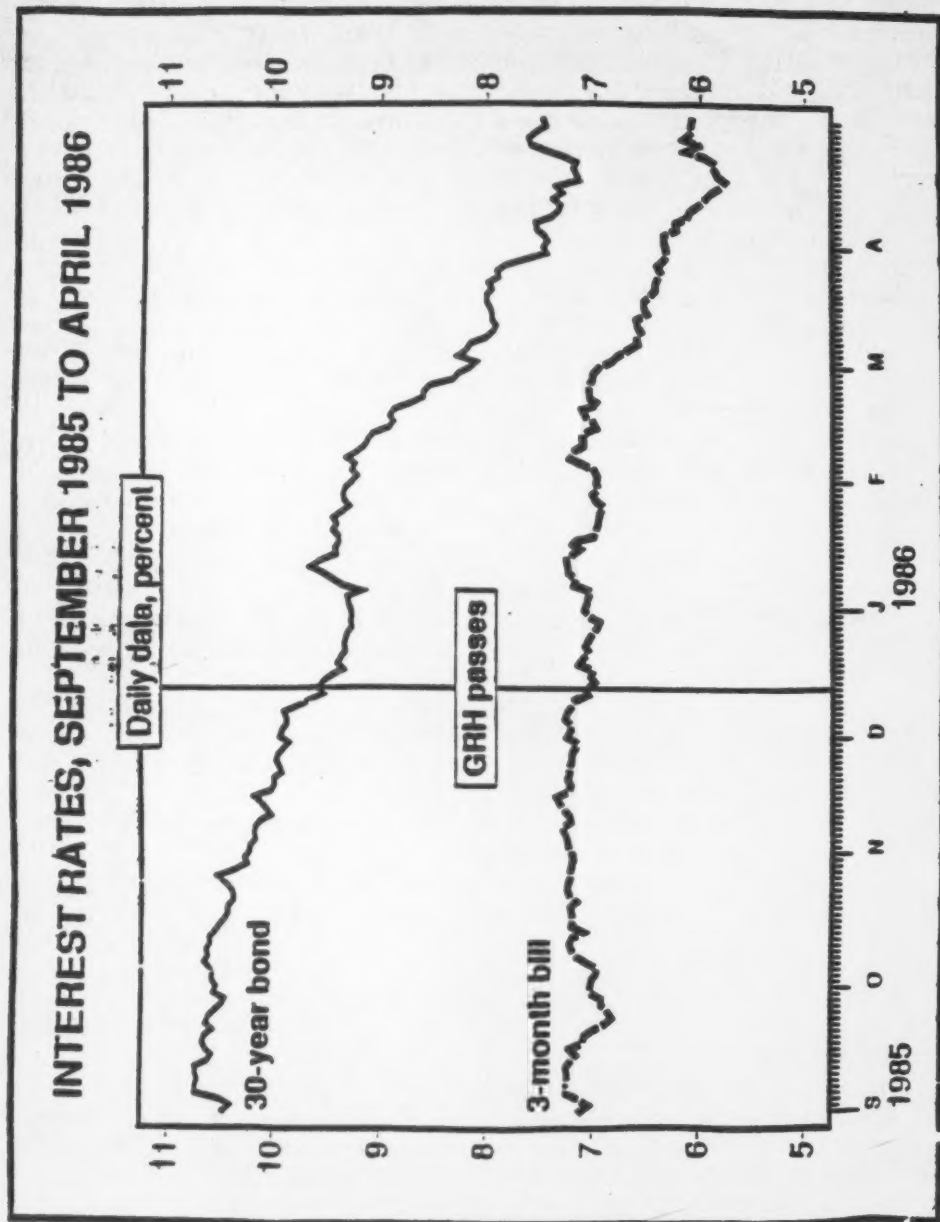
The new reality is that there are no more international boundaries when it comes to the flow of dollars--no border control, no customs officials and no barriers. The influence of foreign financial markets on our economy is great and deep. Most of the world's dollar financial transactions settle daily through New York. Before the advent of instantaneous transfer of information and electronic funds transfers this settling of accounts would have taken weeks, now it occurs every night. There are two "wires" through which the transactions settle. The CHIPS wire which largely handles international transactions, and the Fed wire which handles mostly, but not exclusively, domestic transactions. Last month on average about \$735 billion worth of transactions were settled per day on the CHIPS wire. And the level of activity is increasing on average at a rate of 25 percent a year. If you approximate the international transactions settled via the Fed wire, then about \$1 trillion of international transactions are settled every day on these wire systems. This amounts to \$5 trillion a week, in other words greater each week than our yearly GNP.

Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987 the recorded stock of U.S. assets held by foreigners was almost \$400 billion greater than the stock of foreign assets held by Americans. Ten years ago this difference was \$50 billion in our favor. While one can have different views of how to interpret those numbers, one point is clear -- we cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the Fed wire and CHIPS and the amount of U.S. assets held by foreigners are in a sense a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget deficit. The tally of the world's opinion of our progress is registered every day through CHIPS and the Fed wire. It is vital that we act decisively to preserve that confidence.

Lest there be any doubt about the extent of the world's interest and concern about the deficit, let me share with you some of the feelings of my G-7 colleagues -- who met here in Washington, DC the first week in February. We are engaged in a team effort, the economic policy coordination process, to provide a growing world economy. I have been pressing them to stimulate their domestic economies and open their markets to sustain world economic growth. They, in turn, are deeply concerned about our ability to reduce the deficit. They worry that we lack the strength of purpose to meet the Gramm-Rudman-Hollings target. They are knowledgeable about the details of our budget process and are watching very carefully how we handle our budget negotiations. They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal, that if meeting the \$100 billion target becomes too onerous, we will move the goal line. I assured them on behalf of us all that people in this government--executive and legislative branches alike--are firmly and absolutely committed to meeting the deficit reduction target. I have told them that we will get there one way or the other.

I know you share this commitment. I am delighted to be here today to discuss with you how we can achieve this common goal.



Chairman ROSTENKOWSKI. Well, thank you, Mr. Secretary.

Mr. Secretary, now that the administration has submitted a comprehensive proposal to assist troubled thrift institutions, does the administration have an opinion regarding the appropriateness of extending the special tax benefit rules assisting troubled thrifts and banks, which are scheduled to expire at the end of this year?

Mr. Secretary, there have also been some suggestions from members that we consider accelerating the expiration of those provisions to the date of enactment of the assistance proposal that we are going to be considering.

What is the administration's position on that?

Secretary BRADY. First of all, Mr. Chairman, the administration's position is that with regard to the existing legislation which allows these initiatives to expire at the end of the year—these provisions in the law—that we do not tamper with the law, and they be allowed to expire at the end of the year.

With regard to the suggestion that if the S&L legislation is enacted, that we terminate those benefits, while we have not studied that, we think that proposal has merit and is worthy of real study.

Chairman ROSTENKOWSKI. We have received, Mr. Secretary, much testimony regarding whether the entire savings and loan bailout program should be on budget.

Do you agree, first of all, that the overall costs of the program would be lowered using an on-budget approach, and would you consider such a revision in the administration's proposal?

Secretary BRADY. Mr. Chairman, my feeling is that we have a plan here that will work. The discussion that is centered about whether the cost will be higher, or lower, is focused on whether the REFCORP interest is more expensive than straight Treasury bonds, and our estimate has been that that would be the case, perhaps to the extent of 25 basis points.

We have made the point, at the same time, that the savings and loan industry contributes \$300 billion a year to the REFCORP interest payments. That \$300 billion divided by the \$50 billion principal amount is 60 basis points. So, from our point of view, we feel that the contribution of the industry overshadows the—60 basis points is greater than the 25 basis points that it will cost us to go off budget.

But going on from that technical point, I know there has been a lot of discussion about other plans, and other ways of going at this. I can only say that there is a lot of compromise, and a lot of give and take in the legislation as we have put it forward.

For the 2½ months, or 3 months that we worked with the industry, with the regulatory authorities, with Congress, and with people in the executive branch, there was a lot of pulling and hauling as to what should go where.

I can only say to you that this plan, which has the backing of the banking industry, not the complete backing of the S&L industry but the attitude from the more responsible parts of it, that this makes sense, is an attempt to take the energy and effort of all of the people that have been involved in this problem and move the ball forward.

So there may be other plans, and we would be glad to look at them, but it is a question of what those other plans would produce

in the way of reaction to Congress, and slow the advent of this bill being signed and put into law. So there may be other plans. I would not deny that, but I would more than welcome any attempt by anyone else to come up with one.

I just would reiterate that there is a lot of energy in this one. There are some imperfections in it, but I think we have corralled everybody who has got any input into this problem and kind of moved it towards the finish line.

Chairman ROSTENKOWSKI. Well, Mr. Secretary, I do not intend in any way to delay the action on this legislation. I know how important it is that we accelerate it. But we have had testimony that we could save \$100 million to \$300 million a year if the plan was on budget, and I just wondered whether you had any comment on that?

Secretary BRADY. Well, Mr. Chairman, I am not trying to be capacious, but I cannot comment on that outside the parameters of seeing a whole plan. I mean, if we did it some other way, would the S&L industry be up here complaining to such an extent? Would the banking industry be up here complaining to such an extent that we did not get anywhere?

I can only say to you, that if there is some other plan we would be glad to look at it, but this—and I do not want to be boring on this subject—but this has got a lot of energy behind it, not just Treasury energy, but industry energy, and congressional energy, and it is a plan 330 pages long, with testimony out of the OMB that is so complicated nobody can understand it. And I just would submit that this is the best we can do. There may be some other ways to look at it.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary. Mr. Archer.

Mr. ARCHER. Mr. Secretary, thank you, again, for coming before us this morning.

I think you would agree with me that the Federal Government will never permit its guarantees of deposit to go into default. The President has said that a number of times, and I think the American people should be certain that we will not fail in securing these deposits.

And yet in spite of that, we have seen a \$10.7 billion withdrawal of savings from the S&L's in January, and I wonder if you would like to comment on that.

Secretary BRADY. Congressman, I am glad you brought this point up. First of all, I know everybody on the committee, and certainly everybody in the administration, wants to assure anybody that has got a deposit which carries a Federal guarantee, that that money is good.

That it should not be confused, the discussion—the necessary discussion we are having over this item should not be confused with the absolute total commitment of both the executive and legislative branch to pay those deposits off.

Now, with regard to the outflow of funds, some \$10 billion in January, in one sense it surprises me that it was not bigger. Every nightly news program, every front page of every business section, every business magazine, has got, in black headlines, the \$90 billion, the \$50 billion hole in the savings and loan industry. You can imagine what effect that would have on a person who is not as well

versed as all of we are in the intricacies of the Federal Deposit Insurance.

The effect it would have on somebody in Smalltown, America. All he sees is the morning and evening news saying S&L bailout, or S&L problem, \$90 billion. He says, "Well, my gosh, I've got my money in the S&L. I'm going to take it out."

I am convinced that as soon as we can go through the deliberate and necessary questions and answers that go to considering this bill, as soon as we have got the Congress's imprimatur on some legislation, and the President signs it, we will go back to business as usual, because the S&L industry is a very vital part of this country, and it is necessary, people want it, they are in every small town in the United States, and I think you will see this flow stop as soon as we get the bill through Congress.

Mr. ARCHER. I thank you, Mr. Secretary, and I can say that it is clear to me that there is a strong bipartisan agreement in the Congress to move effectively and rapidly on this issue, and that the public should be certain that these deposits will be protected.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. First, Mr. Secretary, I want to commend you and your colleague, Secretary Bennett, for the courageous and correct action you took yesterday on automatic weapons, or semiautomatic assault weapons.

We have a bill very similar to that, that is moving through the subcommittee right now. We may have some legislation for you to strengthen your hand as you go along.

Mr. Secretary, I have no objection to your plan to rescue the depositors in the S&L's with a minor exception—and it is not minor with me, it is major with me—I just do not think we ought to pass this interest cost off on the generations that are yet unborn, and I, frankly, do not intend to support that part of the legislation.

I think that we can solve it much better with some kind of surcharge, or a surtax, and pay for it. It is our generation's problem. We created the mess and we ought to straighten it out. We should not pass that on to my children and my grandchildren.

What is your response to that?

Secretary BRADY. Well, Congressman, obviously there are different ways of looking at this problem. I must say that there are a lot of things we do, as I view the budget proceedings, where we are passing the cost forward, and I think that although your point is extremely well-taken, the system that we have come up with is one that tries to pay for this over a period of time, and get the industry to go along with it as best we can. We may have a slight difference of opinion.

Mr. GIBBONS. Well, it is not slight, Mr. Secretary. You take \$50 billion and you compound the interest on it, and it has doubled its size in 8 years, and it has doubled its size again in 16 years, and, you know, we are talking about \$200 billion to \$400 billion now of interest that is going to have to be paid on all of this. That is not small in my book.

I have seen the interest costs of this Government go from very minor figures in just 8 years to \$180 billion a year, which was more than the entire Federal budget when I came here, and I just am not going to go any further.

I realize that under Gramm-Rudman we are going to run up another couple of hundred billion, maybe \$300 billion, \$400 billion worth of interest, but I cannot see adding a whole brandnew program, Mr. Secretary. I think that would do more to destabilize the money markets around the world than anything else.

It would seem we would really strengthen the money markets, and we would reduce the interest rates if we would just go ahead and do something on a current basis, particularly a mistake like this which is uniquely our own, a governmental mistake, an institutional mistake.

You know, I am not going to support the part of the program that calls for borrowing money.

Secretary BRADY. Well, Congressman, I can only offer as the other side of the argument, that from what I hear from people who are involved around the world in other finance ministries, the thing that they have their eye on is the Gramm-Rudman target of a \$100 billion, and my feeling on this may be the fact that I am a prisoner of talking to these people—

Mr. ARCHER. Mr. Secretary, that is just a camouflage job. You know they are smart enough to see through that. That is all it is, a massive camouflage job of another part of the debt. That is all it is.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman. Mr. Secretary, it is good to have you before the committee.

Let me make one or two observations first. I want to commend you for your recommendations on the research and development aspect, and to make that incentive permanent. We need that for competitiveness on both a national and international basis. So I commend you for that.

Secondly, I want to make the observation that whatever plan we approach, if you go the REFCORP route on the S&L bill, I want to warn you, or ask you to be mighty careful that whatever we do will not result in dumping properties all across the country.

Now, Mr. Seidman, some 10 days ago, testified that he was going to get a couple of evaluations and appraisals, and he was going to sell that property.

Now when he does that, if he does it—and he said it as bluntly—that means dumping to me, and if you do that, you are just going to wash my State right out in the Gulf of Mexico. So I am just saying to you, whatever the approach, we have got to guard against that because that will cause a great more trouble than we do otherwise.

Secretary BRADY. Congressman, could I just reply to that point because it is very important. I agree with you. I think that particularly with regard to your State, the RTC, which will have these properties inside it, probably has common ground with States like Texas in making sure that that dumping does not take place, because if you dump it you obviously get a lower price, and if the RTC dumps it, that means the cost to the Government has got to go up.

And obviously, with regard to Texas real estate, that is bad as well. So I think we have got common ground there, and that is not our intention. I hope that does not happen.

Mr. PICKLE. Well, I am encouraged that you would say that. I will also say to you that—in line with Mr. Rostenkowski's and Mr. Gibbons' position—would you consider something on budget?

I am a third member of the committee who would like to look at that approach, to see if we could do it. It would save the Government a lot of money in the long-run. But whether we can come up with that, that would be for us to discuss with you, and I think we should do that.

Now, in the area of capital gains, your administration estimates you would have a gain of about \$9 billion over a period of some 6 years. The Joint Tax Committee said you would lose \$24 billion over the same period. Now as one who generally favors capital gains, lowering it, I must say to you I do not think this committee is going to take any action as long as we cannot get those figures adjusted. You simply cannot approach or make a decision when you have two estimates: a plus of 9 and a loss of 24. If you expect to advance that, I must say to you that you have to come nearer on these figures.

Now in your plan that you recommended, you said that if you included commercial real estate in your capital gains plan, that would lead to tax sheltering, so you exclude that.

Now, if you did that, it seems to me like you have really done damage to the long-term depreciable property.

Why did you exclude the long-term depreciable asset?

Secretary BRADY. Congressman, we felt that that area of the economy already had certain tax advantages in the fact that they could write off certain—take certain writeoffs with respect to buildings and properties of that nature.

So, we felt that the incentives in that area were enough, and that they in effect—we did not want to get back into trying to justify what some people call tax loopholes.

Mr. PICKLE. Well, Mr. Secretary, in the 1986 bill, we enacted the passive loss provision, we toughened the minimum tax, we lengthened the depreciation period, and we put limits on the deductibility of interest.

You pretty much have got safeguards against tax sheltering. Now to just automatically exclude depreciable property I do not think is an appropriate approach.

Can you tell me what your gain would be, or your loss would be—however you want to term it—if you did include depreciable property? Your estimate now of \$9 billion, what would it be if you did include that?

Secretary BRADY. I do not have that figure with me, Congressman. I could provide it for you and I would be——

Mr. PICKLE. Well, I would ask one of your staff.

Secretary BRADY. I am told the figure is \$7 billion over the budget period which is——

Mr. PICKLE. I did not hear you. How much?

Secretary BRADY. \$7 billion over the budget period of 4 or 5 years.

Mr. PICKLE. In other words, it would be \$9 billion plus the \$7 billion?

Secretary BRADY. Yes.

Mr. PICKLE. Yes. So it would be a total of \$16 billion in general.

Secretary BRADY. No. Subtract it from.

Mr. PICKLE. Oh, I see. All right. The other way around. Well, I want you to submit those figures to this committee because I think it is terribly important.

[The information of Secretary Brady follows:]

The total revenue effect of the administration's capital gain proposal over the budget period (fiscal years 1989 through 1994) is \$9.3 billion. As shown in Table 2 of the Treasury Department's General Explanation of the President's Budget Proposals, the effect of excluding depreciable and depletable assets and collectibles over the same period is to add \$9.1 billion. Thus, restoring these assets to the base eligible for the lower rate would reduce the \$9.3 billion to \$0.2 billion over the budget period. The \$0.2 billion would increase slightly after taking account of interaction with the 3 year holding period requirement, which becomes effective for transactions starting in calendar year 1983. (Collectibles represent a negligible portion of the total added back to eligible assets.)

Mr. PICKLE. My time is about up, but I will say to you again: you have got to get these estimated figures closer together. Here is the Joint Tax Committee, which is an impartial group, which has nothing to gain politically, which did not run for office, or make any promises about no taxes, and they are saying you are going to lose \$24 billion.

I want to help, but I cannot do it when there is that much disparity.

And one last question—I want you to give it to me, if you cannot do it now—and that is in the area of passive losses in the tax bill of 1986. Cash out-of-pocket expenses, where, if you were in the rental real-estate business, and you were an active participant, and you were substantially involved in it, were denied to the extent they exceeded rental income.

Now it seems to me like that is not fair, and I think in 1986, the members on this committee—on this side of the Capitol—would have given relief in that area because it is very unfair. You cannot even take out of pocket expenses that have actually been paid.

I want to get your recommendation on if we can make some change on that, and if it would not make a big difference in the budget. I would hope you would all give some consideration to it, because it is terribly unfair.

Secretary BRADY. We will look into it, Congressman.

[The following was subsequently received:]

The passive loss rules of section 469 generally disallow losses, including out-of-pocket losses, from a passive activity. It is not true, however, at least for individuals with moderate incomes, that the passive loss rules disallow all losses of active participants in rental businesses. Under section 469(i), individuals may deduct up to \$25,000 of losses from rental real estate activities in which they actively participate. Because this provision was not intended to apply to high-income individuals, the allowable loss is reduced for individuals whose adjusted gross income exceeds \$100,000 and is not available to individuals with adjusted gross incomes of \$150,000 or more.

We believe that the out-of-pocket loss from an activity may bear no relationship to the real economic income or loss from the activity, and that the allowance of out-of-pocket losses from a passive activity is, thus, inconsistent with two of the fundamental premises of section 469. First, Congress determined that, in the case of a passive activity, only real economic losses should be allowed to offset nonpassive income. Accordingly, expenses from a passive activity (including out-of-pocket expenses) are allowed to offset nonpassive income only to the extent they exceed income from the activity, including income attributable to appreciation of the activity's assets. Second, Congress also determined that the existence and amount of a taxpayer's real economic losses from a passive activity should be ascertained only when there is a complete disposition of the taxpayer's interest in the activity. Thus,

tax losses from the activity (including out-of-pocket losses) are suspended until the offset or until the disposition occurs. In effect, the passive loss rules provide that an out-of-pocket loss from a passive activity is not a real economic loss that is recognized for tax purposes if it is recouped out of subsequent income from the activity or gain on its disposition.

The passive loss rules may be less accurate than a system in which economic income or loss is measured on an annual basis. Under such a system, out-of-pocket expenses would be deductible, except to the extent they were required to be capitalized. On the other hand, the measurement of economic income or loss on an annual basis would necessitate a mark-to-market rule under which unrealized appreciation of assets during a year is included in that year's income. Consequently, in many cases in which a taxpayer is out of pocket, the taxpayer's expenses for the year would be more than offset by unrealized appreciation in the activity's assets.

We view the passive loss rules, which disallow certain losses but do not require the recognition of unrealized appreciation, as a reasonably accurate approximation of economic income or loss. Thus, we do not believe that the disallowance of out-of-pocket losses from passive activities is unfair. In any event, the measurement of real economic income or loss on an annual basis was rejected for reasons that include the practical difficulties involved and the desire to retain the availability of certain tax preferences in appropriate cases. We are not aware of any change in circumstances that would justify the reconsideration of this decision.

The allowance of out-of-pocket losses, without offset for unrealized appreciation, would have a significant effect on revenues. Moreover, the indirect effects of such a change could be even more significant. The passive loss rules are only one of the many base-broadening provisions contained in the Tax Reform Act of 1986. We are concerned that the allowance of noneconomic losses under section 469 may lead to requests for similar relief by taxpayers adversely affected by other base-broadening provisions and that the ultimate result of such a change might be the reversal of a substantial portion of the 1986 reforms.

Secretary BRADY. Could I just reply for about one second to the important question you have raised on the revenue estimates, the Treasury estimates being different than the CBO estimates.

I must admit, as a newcomer to this process, I am as mystified as anybody else as to why these estimates are so far apart. I can only tell you with regard—and I do not know the process that is used by the CBO. I can tell you about the process in the Treasury.

I do not know any of the estimates personally, and that is by design, because I think what we ought to have is, not having the Secretary coming up with ideas and then trying to tell the estimators how they want to have it come out.

So, when we try some of these various plans that have—various ideas that have wound up in our capital, in our revenue suggestions, we hand them over to the estimators to see what they are going to make of them. I do not know who these people are, men and women are.

I just want to assure you there is nobody beating them over the head trying to get them to go one way or the other. That is what they produce, and I am as mystified as the next guy as to why it is different.

Mr. PICKLE. Well, I agree with you, Mr. Secretary, except I think you would agree that we must get those figures more in line with what we think are the facts.

Chairman ROSTENKOWSKI. Mr. Schulze will inquire.

Mr. SCHULZE. Thank you, Mr. Chairman. Mr. Secretary, I join the chairman and others in welcoming you to the committee. It is a pleasure to have you here.

First of all, in line with the relief to the savings and loan situation, when you were discussing options, did you look at all at the utilization of passive losses for distressed properties?

All of the people I have talked to—both in the business and in the industry, mortgage bankers, and others—seem to think that we could get a bigger bang for the buck by the proper utilization of passive losses in narrow usages.

So I guess my question basically is, during the discussion of options, and when you were working on the proposal, was this one of those items discussed?

Secretary BRADY. Congressman, my recollection of the exact details of every option is a little hazy.

As I remember, we did think about that, and our conclusion was that although it was a good idea, that it did not make that much difference, but we can take another look at it and get back to you.

Mr. SCHULZE. I wish you would.

[The information of Secretary Brady follows:]

Yes, we did consider such a proposal; however, we determined that it did not make sense to include it. Providing selective relief from the passive loss would probably be quite complex, and we believe that as a matter of tax policy it was better to not follow that approach in structuring our savings and loan proposal.

Mr. SCHULZE. I have talked to Joint Committee, and I sort of sense a little bias against restoring passive losses. Let us forget that bias. If we get the biggest bang for the buck, and I have gotten some figures that it could dramatically help the situation in the Southwest and other areas, we would utilize fewer taxpayers' dollars in the long run. So I would hope that you would take a look at that.

Mr. Secretary, in regard to capital gains and capital gains on housing, as you know under current law there is a \$125,000 forgiveness if a taxpayer of 55, or older, sells his home.

If we take the example of an individual or a couple, let us say, who sold their home for \$325,000, the exclusion amount is \$125,000 and the recognized gain is \$200,000, would the \$200,000 recognized gain be subject to the 45-percent exclusion, or would the full amount of the \$325,000 be taxable?

Secretary BRADY. If you would permit me, I would like to ask Dennis Ross who is Assistant Secretary for Tax Affairs.

Mr. Ross. Mr. Schulze, it would only be the \$200,000.

Mr. SCHULZE. The gain.

Mr. Ross. The \$125,000 exclusion would be retained.

Mr. SCHULZE. OK. I have, as perhaps you know, a proposal which would totally eliminate capital gain on the sale of a principal residence.

It seems to me that if we are looking for simplification, this idea eliminates all of the recordkeeping that we are forced to do in roll-overs over the years, and it eliminates also that incentive to buy up as you go along.

I know that you do not have a revenue figure on the top of your head, but if you have time, some time, I would be interested. I have gotten various estimates, some as low as between \$300 and \$400 million a year. If we do end up with a figure in that area, it seems to me the simplification is probably worth \$300 to \$400 million a year, not to mention what we would do for senior citizens. So if you have an opportunity, I would hope that you would look into that.

But before we get off the rollover situation, how would you treat—maybe Dennis would want to answer this one, too—how

would you treat a partial rollover, where you sold the principal residence—again in a senior citizen type buy-down by going to a smaller place—and only took a portion of that as capital gain. How would the exclusion work?

Secretary BRADY. Congressman, could I just answer, and then Dennis can pitch in if you would like.

Our position at this point is that although we think there is great merit in the ideas that you have put forward, that the benefits we already give taxpayers for rollover in their principal residences—basically that there is no tax involved, if they are reinvested in a residence of greater value—is a pretty darn good break. And also as you have mentioned, we give a break to senior citizens, even more further along than that.

I think that your suggestions are very good ones, but in an era of budget stringency, are ones that we feel really should take a little bit further study, but they are very good ideas.

Mr. SCHULZE. Thank you. Maybe Dennis wants to address that.

Mr. ROSS. Mr. Schulze, in the partial rollover situation to the extent—because of only the partial rollover you recognize gain—the exclusion would be available, so—

Mr. SCHULZE. OK. One other question. Under your capital gains proposal, if you have a depreciable asset but you opt not to depreciate it, would it then be available for the favorable treatment?

Secretary BRADY. To be perfectly honest with you, I would like to get back to you on that.

My understanding is that the election is not at the taxpayers' hands, but perhaps in the writing of the law, there has been some change.

[The following was subsequently received:]

No. The proposal excludes property of a character subject to depreciation; thus, a taxpayer would not have such an option.

Mr. SCHULZE. If we implement such a proposal, should we consider making the optional depreciation part of it.

Secretary BRADY. Well, what we were really aiming at here was something in addition to capital gains—just the pure advantage that you would give somebody, and incentives we would give somebody—is to try and stretch out the investment horizons of people in the United States.

What we thought would be appropriate in that regard is the 3-year time period, which ought to be phased in over time in order to let people get accustomed to that.

We thought that there was, again, more bang for the buck in terms of trying to stretch out people's investment horizons, and therefore, stretch out the investment horizons of managers of businesses, if we focus that on the sales of stocks and the like, rather than buildings and that sort of thing. So we had kind of a little bit of a different agenda than just the one that you have suggested, Congressman.

Mr. SCHULZE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for your testimony.

Let me follow up just a moment as a supporter of the differential in capital gains through the years. I do have some problem with the distinctions that have been made.

You indicated to Mr. Pickle, I believe, that part of the difference, maybe in the revenue estimates, had to do with—I am assuming that there would be a churning effect as far as stocks are concerned?

Would there be an incentive to get out of the short-term into the longer-term—

Secretary BRADY. Would there be a churning effect? Well, I think the long-term effect would be less churning. In other words, the people would make investments for the long-term, that they—you know, the time horizon that we now have for capital for people who are making investment decisions is as long as it takes to make the profit.

A fellow buys a stock for \$15 and it goes to \$60. Ten minutes later, he is gone. That is his investment horizon. So the import of this plan is to try in over time—not right away, not tomorrow—to give a benefit to those people who are willing to lock up their savings for 3 years.

It seems to us they would do that based on examining the plans of the corporation in which they were about to invest, and they would want to make sure that this corporation had plans that they could stick with, because they get more of a profit in that particular regard. So I think the long-run effect will be less churning.

Mr. JENKINS. Well, I was trying to determine the disparity between the figures that we have. One is showing a net gain for the Treasury, and the other indicating that we would have a loss to the Treasury.

Secretary BRADY. I cannot give you the exact difference for that reason, for that result, Congressman. I can only say that among the fraternity of revenue estimators, it is our understanding that our revenue estimators are in the middle of the range of assumptions that determines how fast that things will turnover, and the CBO estimators who are at the end—you know, the other end in the framework.

But that would be something. You would have to get them both in the same room and see what they come out with. I think that their assumptions are different than ours, and we think that we are in the middle of the spectrum. We think that they are over on one side—the pessimistic side of the spectrum, but they might feel the same way about us.

Mr. JENKINS. Someone on your staff indicated that if we included depreciable property, we would lose some \$7 billion, I believe, in revenues.

Why is it that we would lose revenues on depreciable property, and we would not lose money on stocks and bonds?

Mr. Ross. Mr. Jenkins, our analysis shows—and I think the Joint Committee may agree with us on this. I am not certain.

But our analysis shows, in any event, that the depreciable assets, or the sale of the depreciable assets, are less sensitive to changes in the capital gain rate and assets such as corporate stock.

Mr. JENKINS. I do not know that I follow that.

Mr. ROSS. Business circumstances, cycle of replacement, and a variety of nontax considerations are more likely to determine when a depreciable asset is sold, than in the case of pure investment assets, such as corporate stock.

Mr. JENKINS. So the Tax Code would have more influence upon stocks than it would upon depreciable property?

Mr. ROSS. The tax rate on the gain would have more influence, yes.

Mr. JENKINS. I am trying to make the distinction now between depreciable property that loses money if you get a lower rate, and stocks and bonds suddenly gain money with a lower rate. It is still difficult for me to follow, to rationalize, between the two.

I would like to pursue that with you, and maybe you can convince me.

Secretary BRADY. Why do we not have a private discussion on it. If you would like, Congressman, we can get into it.

Mr. JENKINS. I would like——

Mr. PICKLE. If the gentlemen would yield, I would like some figures on that, as to your reasoning and how you estimate. I would be glad to talk to you personally, but I would like to see what the facts are.

Secretary BRADY. Congressman, why do I not ask Assistant Secretary Ross who has been involved in the details of that to answer the question for you.

Mr. PICKLE. All right.

Mr. JENKINS. Let me ask a final question. I appreciate the indication of the great need that we have for the international financing market, and obviously, they are contributing a great deal right at the present time to our deficit problems by investing foreign markets.

Obviously, it would be better if we had a higher savings rate here, so we could finance our own deficit, if we have a deficit, which we do.

Outside of the capital gains differential proposal, is there anything being proposed that would give an incentive to private savings? Do you see anything on the horizon to encourage private savings?

Secretary BRADY. Congressman, there has been a lot of discussion in this country as to what we can do, and we tried the IRA accounts some number of years ago, and of course, they were discontinued recently.

One of the arguments that was used when they were discontinued is that they were not really producing any more savings. They were just transferring savings from one place to another.

I think what we have is a problem in this country where we are consumption oriented, rather than savings oriented. We have tried to put in our suggestions here, our revenue suggestions, the capital gains incentive, which we think will produce the revenues that are set forth in this table.

Mr. JENKINS. Would we be better off, really, to have maybe an exclusion for any interest earned from any Federal taxation up to \$7,500 or so a year to increase this private savings rather than——

Secretary BRADY. I think there are a number of things that you could do. The Japanese are experts at it, but they generally go—

they do not worry as much as we do about whether certain parts of the investment spectrum are being aided or benefited.

So the answer is that if you did do this, you would have to go—changes in the revenue code, which would benefit those people that had the savings, and generally speaking, the people that have the savings are in the middle income and upper income classes, and then you get into the discussion as to whether they should be getting tax breaks, rather than focusing on whether they are going to produce the savings.

We could do it, but in this period where we have such a narrow pass to get through in order to reach the Gramm-Rudman targets, it is probably not worthwhile trying to put those proposals together at this time.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you. Mr. Secretary, if I can just change the topic for a moment, and ask you about your international debt relief plan that you discussed the other day.

Can you give me some idea of what the incentives you have in mind for the banks to participate in this plan, and whether or not there will be any budgetary impact on these incentives this year?

Secretary BRADY. Mr. Downey, we have the—if I can take just a minute to talk about the debt plan?

Basically, what we did last Friday was to put forward some ideas of how we might change the approach to Third World debt. That fundamental change was aimed at a number of things, but perhaps the most important thing that was aimed at, was trying to reduce the level of debt, rather than have every negotiation wind up in addition to the level of debt.

So we said there are a number of things that you have to do in order to try and get that down. Two of them, I would say, in two respects, they will affect the banks.

One is, there are certain regulatory aspects of how banks account for losses that should be examined. We are not saying that anything should change, but that is an area that should be looked at.

The second area is the actual—and I do not want to get too detailed, but this is a detailed problem.

One of the things that stops more debt reduction from taking place is the so-called labor and sharing agreements in bank loan syndicates, whereby the bank syndicate says that if there is any money coming back from a country, that it has to be shared ratably with each member of the group. And one thought would be, "Gee, that sounds fair."

But the truth of the matter is that it stops any kind of commerce from taking place, because the process is so cumbersome. So we have said that we should have a look at that.

Now, I will stop in one second, but when we laid out the ideas behind this plan, what we were really saying to the world was, "Come see us."

We think that we ought to aim in a slightly different direction—in fact, not slightly. We ought to change our focus toward debt reduction and away from having every negotiation start out with great intentions but wind up adding to the total amount of debt we have in the world.

So, what we will have to—you know, this will involve talking to the members of the G-7, the World Bank, the IMF, the debtors, the creditors, the regulatory agencies, and the Federal Reserve. It is a composite process, and it is so complicated, I will only leave it at that.

Mr. DOWNEY. First of all, let me just say that I personally think that that is the right direction to move into debt relief. I think the former policy was tried and was not successful.

Can you give us any indication—I mean, I realize the complexity of it—do you anticipate that in this fiscal year there will be a revenue impact that you might be coming to this committee and saying—you know, change their bad debt reserve, or maybe we want to use a carrot and a stick approach to some of our U.S. banks with respect to whether or not they participate in this plan.

Because personally I believe that during the early eighties, these banks did very well with these foreign loans, and frankly, should be asked to belly up to the bar of sacrifice, at this point, and I would hope that—I guess I am kind of leading you down this path—I would hope that if you are going to come to us for some incentives, that any incentives that the taxpayer has to bear to bring these banks to the table, be done in a way that they are satisfied that the banks have done more.

Secretary BRADY. I think it is too early to answer that question. We do not have a plan now which includes such incentives, but if the very last part of getting the Third World debt situation resolved involved banks taking write-offs, then that is something we ought to look at.

But it is such a complex problem, Congressman, I think we have to wait for these individual negotiations to show where we are going.

Mr. DOWNEY. Can I ask you—and I realize it is far too complex for a 5-minute question and answer period to develop anything—Treasury Secretary Baker had in mind a more case-by-case approach to the problem.

Is there any thought on your part that maybe we should abandon this idea of case-by-case and look to more broad principles with respect to how we treat whole classes of debtors with respect to relief, rather than waiting for each crisis to develop, whether it is a gasoline crisis in Venezuela, the election of the Peronistas in Argentina where they are claiming in their campaigns that they are going to boycott their debt payments?

It would seem to me that maybe—clearly, we are not going to ignore case-by-case examples, but rather for our own purposes of analysis, that it might be better to establish some broad principles that people can understand, so we do not just continue to react to crisis.

Could you comment on that?

Secretary BRADY. Yes. I do not think we can abandon the case-by-case method, and I know you are not suggesting that. Because what happens is that the way these things take place is, first, the Mexicans come in, then the Venezuelans come in, then the Brazilians, then the Argentineans, then the Chileans, then the Costa Ricans.

It is a one-by-one process, and I think what we have done, Congressman, is to suggest the idea that let us stop thinking for the moment about negotiations where debtors and creditors get together and there is a gap to be filled.

In other words, we wind up saying, "OK, the answer to this is, we need \$2 billion, because we want to keep the debtors in the position of paying principal and interest." The banking system in our country wants that.

What we are saying is, "Let us not set the process. Let us not set our thinking towards that. Let us try to set it over here, where the process itself is aimed at debt reductions."

So the banking system can enter into negotiations with the debtor nations and try to reduce the stock of debt. Maybe allow them to—and provide the debtor nations with some facility. I do not mean a grandiose facility, but some way of getting the money and organizing themselves, so they can think about debt reduction instead of adding to the stock of debt. So I think you have to do that.

It would be impossible to come up with a grandiose solution, because it would not fit the particular cases. I think we have to take the guy that is before us and deal with him, and see if we can reorient it this way, and then maybe the next fellow that comes in will say, "Hey, that was a pretty good idea. Let us try that again."

Chairman ROSTENKOWSKI. Mr. McGrath?

Mr. McGRATH. Thank you, Mr. Chairman, and thank you, Mr. Secretary.

In your testimony, you articulated the administration's position which is to allow some of the provisions in the S&L tax provisions to expire by the end of this year.

I am wondering since the R&D credit and the allocation of that credit, is fully funded in the budget, plus nine or ten other expiring provisions due to expire as of the 31st of this year—whether or not the administration's position would be to allow those to expire also? These are things like mortgage revenue bonds, small issue IDBs, targeted jobs tax credits, educational assistance tax credit, legal assistance—that are due to expire at the end of the year.

I am wondering whether or not the administration has a position on those at this point?

Secretary BRADY. Our position is that we are going to allow most of those to expire.

Mr. McGRATH. Thank you. Mr. Secretary, we had a private conversation on the S&L issue yesterday.

In regard to the S&L problem, we have had this problem going back perhaps 6 or 7 years.

In New York State we had this problem some years back, and some healthy S&L's and savings institutions came forward and with a handshake with the Federal Home Loan Bank and FSLIC and others, provided a phoenix for some of the distressed banks in our area.

The new S&L bailout plan takes a different tact, because it eliminates some of the provisions that were agreed upon some years back in terms of goodwill.

I am wondering whether or not we could grandfather some of the arrangements that were made in good faith, going back some years,

so that we do not put these phoenix banks in the same position that we find some of these distressed banks that we have today.

Secretary BRADY. Congressman, we did talk about this yesterday, and since the time that you and I had the conversation, I found out that this is an item of discussion between the Treasury officials that are responsible for this legislation and the people that you are referring to.

So you have a good point. We are trying to see if we can make any accommodation there.

Mr. McGRATH. Thank you, sir. One further question, that concerns capital gains. I would like you to perhaps put yourself in the position of somebody who sits on this side of the table.

With all of the discussion regarding either the gain or loss in revenue on the capital gains proposal, if we would agree that there is a capital gain revenue loss, there has been some suggestion by members on this committee that to compensate for the revenue loss, we would increase the top marginal rate in order to compensate for that particular loss.

I am wondering, if you were on this side of the equation, which way you would lean in terms of what is best for our economic picture?

Secretary BRADY. Congressman, I am very mindful of one point. I am mindful of it, because Chairman Rostenkowski has made it very clear to me his feelings on this matter over time, that we made a deal in 1986, and this is not the time to undo that deal.

But the Treasury came at it from a different point of view. We came at it from the point of view of how can we possibly take a step toward getting people to think toward longer-term horizons, and not be a country which is involved in financial engineering by Wall Street and various takeover groups around the United States.

How do we do that? Well, we took one crack at it. It was to try and look at the ERISA laws and see if we can make a change in the interpretation of the ERISA laws, so that a guy did not have—that somebody running a major pension fund, did not have to sell his stock just because he wanted to make a quick buck, that he could rely on the long-term plans of management.

So working with the Labor Department, we got that changed, and I think anybody who now goes and asks for an interpretation of the ERISA laws will be told that you do not have to take the quick buck, that you can look at long-term.

And then we said, "Well, what about investment? This churning that everybody complains about on Wall Street?" And we hear it everywhere that, you know, "What is going on?" The churning that is going on has no bearing on what the real world inside of the United States is doing in terms of industrial activity.

So we said, "Let us try and give a benefit to those people who are willing to look long-term and willing to make investments based on management saying, 'We are going to do this and this over a period of time.'" So that those managements are in a better position to compete with the Japanese and the Germans and the Koreans.

We simply cannot compete with these people if our investment horizons are no longer than 10 minutes, or however long it takes the stock price to go up.

So, I was not trying to get into any argument with this committee, and particularly Chairman Rostenkowski, because I know that is not a very good idea, but I was saying, "Let us try and look at this a different way. Let us try to see if we can do some things which will get our investors in this country, and therefore our managers, and therefore our corporations, aimed at long-term plans."

Now, it is not perfect, but I think it is a very good and useful first step. I did not answer your question about 2833, but that was not part of our thinking. I can understand the rest, how it might be—

Mr. McGRATH. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

I guess I would like to make a comment and then ask you a question. Regarding deficit reduction, you said in your testimony that the strongest tool of the Federal Reserve for curbing inflation is to affect interest rates, and that the strongest tool of the administration and Congress is on the fiscal side, that is, deficit reduction.

I agree with you. I do think, however, that it is important if we have deficit reduction—and I think you would agree—that it be credible deficit reduction.

Chairman Rostenkowski today, as he has in the past, stated his belief that credible deficit reduction requires a balanced package of both revenue and spending cuts.

My concern is that without revenue in the picture, we will again, as we have in the last 3 or 4 years, resort to gimmicks, and blue smoke and mirrors, to reach the Gramm-Rudman targets.

You are aware of the controversy over taking the S&L bonds off budget, adding their part of the long-run cost. You talk about long-term interest costs, and that is a factor there. Mr. Gibbons is particularly concerned about that.

Surely, if we do not deal with revenue, the negotiators will go to \$109.9 billion as the target, the maximum allowable differential allowed by the Gramm-Rudman law.

It seems to me that if we do this with gimmicks, and blue smoke and mirrors, stretching every single point, using the most rosy scenario, that we are not going to have a very credible deficit reduction plan.

I mean, if you ask people whether the odds are, at the end of this process, in September, that we will be over, or under \$109 billion in actuality, for fiscal year 1990, that most people will say we are going to be over \$109 billion.

And it would seem to me that considering the stakes involved, the Treasury and the administration would want to be as conservative as possible. It seems to me you are being as optimistic as possible.

Certainly, if it is not a credible package, as you point out in your testimony, your own economic assumptions are not likely to prove correct, especially in relation to interest rates, as the Federal Reserve will surely try to push interest rates up further, and that, not so incidentally, will cause you further problems in trying to deal with Third World debt.

Now I realize that you and the administration cannot change your public stance on revenue as part of the package as you go into negotiations, but I just have to say for the record that in my opinion, it is a very risky course that you are running.

Now I want to turn to savings and loans and ask you a question. One of the things that we ought to do—I hope you would agree—is not only take care of the current situation, which I think the administration is commendably trying to do, but also try to prevent recurrence in the future of the same sort of problems.

And it is easy now to say, well, we made a mistake this time, we did not regulate closely enough, we did not have enough auditors, and so on, but we will do that in the future. I am not so sure that that is reassuring.

One of the factors which has exacerbated and worsened the situation that we are now in is the brokering of jumbo CDs, in directing large sums of money to these troubled S&L's.

I am wondering if the Treasury has any position on the role of brokered jumbo CDs, and whether you have any recommendations or plans to try to curb them in any way in the future?

Secretary BRADY. Congressman Pease, the way we have dealt with that in our S&L plan is to leave that, or to place that, rather, responsibility with the FDIC when and if the legislation goes through.

So we think this is an area they should look at, and look at right away, and we would leave pursuit of that problem to them, because we think it is a moveable feast, and you do not want to put regulations in there which might work today but be a hindrance tomorrow.

Mr. PEASE. All right. Thank you. Just finally, as my time is about to expire, I want to correct a statement you made in response to Mr. Jenkins, and the availability of savings incentives for American individuals.

You talked about IRA's in the past tense, and said they were discontinued. Of course, as you know, the IRA is fully deductible, and still an option for the vast majority of American taxpayers.

Secretary BRADY. Yes.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. Mr. Secretary, let me preface this by saying I have great admiration for your record of service in the private and public sector.

I want to ask a couple of questions, again about deficits and the budget. You know, you face some skepticism here on Capitol Hill about the economic assumptions, and I would guess that you understand why that skepticism exists.

We look at the economic assumptions and see that, for example, in interest rates, you portray a downward trend in interest rates to 3 percent in 1993.

And then we raise our eyebrows and say, well, this looks like it is just another chapter from the same old book. And what you have said today—and I read it carefully and listened carefully—you said that interest rates will drop when the world sees that we are serious about reducing the deficit.

But in fact when the world sees the economic assumptions in the deficit you present, doesn't it see just exactly the opposite? That we

are not serious; that this is another chapter in the same old approach. Use optimistic assumptions to portray a lower deficit.

I am wondering if this is not kind of a circular logic that does not go any place, and that interest rates have been rising recently because people understand that this is not a serious approach. When we get serious we will use very realistic assumptions.

We will use whatever is necessary on the revenue side, and the expenditure side, to reach the objective.

Secretary BRADY. Well, Congressman, first of all, I do not defend Gramm-Rudman as the be-all and end-all, but it is the sanity that we have in the system at this particular point in time.

So, aiming at that goal line I think convinces the rest of the world that at least we are headed in the right direction. And I do believe interest rates will come down, but the economic assumptions, to me, that we have included in the budget with regard to growth are—as I mentioned to you, the administration has underestimated four times in the last 7 years, and overestimated three. And the figures that we are including for this year are about the same as they have been, for average, over the last 40 years.

So I can see that the process is not perfect, but, to me, it is as—you know, people forecasting interest rates is, to me, kind of a game that is pretty hard to win. If people could do that, there would be an awful lot of rich people who would be gambling in the bond market.

I just do not think it is possible. So what I tried to say was look, interest rates, when I started in business was 2.5 percent. They went to 14. They came down to 7. They went back up to 9. Now I am not sure we are going to reach 3, but I think we can come an awful lot lower.

Mr. DORGAN. Yes, but just between you and me, these interest rates are awfully optimistic. I would guess if you and I, and a number of others were sitting around here trying to figure out what do we really think is going to happen here, you would not be predicting 3 percent interest rates in 1993.

Secretary BRADY. Well, I think if we can get some closure on a budget, agreed to by the President and Congress, that you are going to see a movement in interest rates which will take the—downward—which will take the focus of discussion away from whether these interest rate trends are wrong, or right. Now if we do not come to that, then I agree with you. I mean, that they are going to stay up until we do.

Mr. DORGAN. And the only point I was trying to make is that the prospect of that closure is a prospect that is not enhanced at all by overly optimistic assumptions. So I would agree with you: if we come to some closure on the deficit in a real way, likely you would see some impact on interest rates. But the interest rates you use in the assumptions themselves make the prospect of closure less likely.

That is the only point I was trying to make, and I wanted you to understand why there is this enormous skepticism with respect to these numbers.

We have been through 8 years of budgets that really have been gamed in dozens of different ways, to show things that are not ex-

actly the case, in order to demonstrate to the public something is happening that really is not happening. So that is our skepticism.

Let me ask, very quickly, about savings and loans. I asked the Federal Home Loan Bank Board for some information about savings and loans' purchase of junk bonds, and the answer is, well, it is not very significant. I said can you send me a list of the 10 savings and loans that hold the largest portfolio of junk bonds in the country, and they have done that, and asked that I not make that public, and I shall not.

But I want to ask you: As I looked down the list, it was fascinating to see that one savings and loan, for example, has 34 percent of its assets in junk bonds.

Does that represent to you, as it does to me, some colossal failure some place in regulatory authority? Somebody apparent is not looking. Does that concern you?

Secretary BRADY. Well, I do not know whether it is regulatory authority or not, but I agree with your conclusion. But I would say to you that perhaps if that savings and loan operator had more of his own money up ahead of the Federal guarantee, he would not take that kind of a risk, and that is just where this program is aimed.

In other words, make these fellows put up their own money before we let them use the Federal purse in order to attract deposits to allow them to go out and buy the junk bonds that you have alluded to.

I think that you will see a lot less of that if we can get this legislation through, Congressman Dorgan, and I agree with you—34 percent in junk bonds does not sound like financing the future home ownership of the United States, to me.

Mr. DORGAN. Especially if purchasing junk bonds which are, by definition, higher-risk instruments, by an institution who knows it is going to be bailed out by us, by the taxpayers. It seems to me that while we do not have a lot of them in that situation, it seems to me there is something wrong, some place, that we have to fix in the regulatory scheme of things.

Plus I accept the point you make legislatively, and think it is something we need to consider.

Mr. Secretary, thank you very much for your response.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Secretary Brady, I think most people agree that we ought to have an early resolution of the savings and loan problem, and we are told by the League of Savings Institutions, that if there is a premium rate, that as many as 70 savings and loans may go into the red, and I wonder what your assessment of that reading by them is.

Secretary BRADY. Well, I cannot comment on the exact number, Congressman, because everybody has a different way of calculating that number, but I would just venture a more general point which is that any time you apply the heat to an industry, as we have during this legislation, you are going to get a lot of people on the other side saying we cannot live under this regime, it will not work, you will deplete the industry, and you are trying to drive us out of business.

I have somewhat of a tin ear for that, although I think a lot of their concern is well placed, because I lived through the securities industry when we went through this exact same kind of thing. They outlawed the fixed commission which provided an enormous source of revenue to us, and we said, well, if you are going to do that we are all going to go broke. We will not be able to last.

At the same time, we had a lot of back-office trouble in the industry, and six or seven of the biggest firms in the industry went out of business, and the profitable firms had to pick up the tab. This is exactly what is happening to this industry.

We said we did not do that. You know, why should we pay? We cannot stand it; we cannot afford it.

All I can tell you is that 15 years later, the industry is about 10 times as profitable as it was then. So the exact number I cannot comment on, but all in all the fact is I expect to see a healthy S&L industry out there in the future, and I think there are some corrections that are being made here. They are tough, but in the main, they will produce a stronger industry.

Mr. COYNE. Well, in the event that some number close to that, 65, 70, or whatever it might be, does occur, will that adversely affect the President's proposal?

Secretary BRADY. I think the President's proposal is pretty conservative. We did so in terms of the resolutions, for two reasons. One, we did not want to be predictive about the level of interest rates. If they go up, the problem gets worse; if they go down, the problem gets better.

Nor could we exactly pinpoint the number of institutions that would be adversely affected. So, in trying to come up with a figure of \$50 billion which is what REFCORP is organized to take care of in terms of resolutions, we looked at a figure of resolutions which produced \$18 billion worth of losses.

Now we said to ourselves, well, those are the book losses. They are going to be worse than that. So let's double that to \$36 billion. We just did not double it, but we analyzed each of the individual ones and came out with a figure, after saying 30 percent more here, 40 percent there, up and down, to \$36 or \$40 millions, and then we—\$40 billion—and then we said, well, we need a cushion of \$10 billion just to make sure that we—you know—we have some room in the process in case we are wrong.

So I think we have got enough wherewithal in the program to take care of the things that you ask us about.

Mr. COYNE. On another subject, in your testimony, you indicated that there would be an exclusion of capital gains tax for those who earn under \$10,000 per year.

In your testimony, you indicate that there would be a 100 percent exclusion for them. Do you have any indication of the number of people who experience capital gains with incomes less than \$10,000?

Secretary BRADY. I cannot give you the number of people. What I can do is give you what the two—for once, the CBO and the Treasury estimators were pretty close.

The steady-state figure we have in the Treasury estimates is \$300 million a year. That it would produce \$300 million of revenue. And

the CBO estimate I think levels out at \$400 to \$500 million. So they think we will be even more successful.

We came up with this idea of let's see what it produces, and that is what it produced, Congressman Coyne. Let me say that don't forget that this is not just securities; this also applies to home ownership, so that it could come from there.

I do not know. The revenue estimators—I thought if they came up with \$10 million, or \$20 million, or \$30 million, it would be a joke, but once they came up with this kind of a figure, I said let's put it in there and see whether it is there, and let them get the benefit of it.

Mr. COYNE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman.

Mr. Secretary, you have been before many committees in both Houses. You have answered every imaginable question over the past month, and I want to congratulate you on the way you have handled yourself. You have done it at a time when the market has gone the other way from some of the basis assumptions that were made as interest rates have been going higher, there have been fears of inflation, and there have been many people who have been lowering their estimates of the 3.5 GNP estimate that has been made for our growth.

In fact I have seen many figures that have come down, not only 2.8, but to 2 percent, which would impact on the \$82 billion that we are counting on growth in order to balance the budget, and which would be additional revenue.

And when we look at the S&L problem, and how we are going to solve it, the drought fears that we have, the nuclear waste disposal that we have not even winked at yet, and we know that is almost a \$150 billion problem, and the Third World debt which, of course, there is nothing in our budget regarding that, and we know that we are going to have to face that—we have really many, many concerns as to whether or not we are going to face a Gramm-Rudman surprise on August 15 when we take our snapshot.

Our production is near capacity, our unemployment is high, and the fear of inflation is real. And of course we do not have any contingency to back us up, just in case the worst scenario comes out.

And in regard to the Third World debt, I wonder whether or not—and you will be sitting in on those meetings—there is going to be any synergism between the drug problem that we have, where we spend almost \$200 billion a year for health services and law enforcement, and loss of capacity, and social services that we deliver, that this drug problem has cost us in America.

And it would be a very cheap quid pro quo if we could help forgive some of the debt to some of these Latin American countries, if they would stop the production of the marijuana and the cocaine, and the heroin, or whatever drugs are coming into this country.

I hope when you sit down with the Group of Seven, and you sit down with the Third World countries and discuss the debt, and the partial reduction of the debt, that the drug problem does come up, because I think it is one way that we can get some benefit from their cooperation.

And when we are talking about that, too, I do not think you are ever going to solve the Third World debt unless you really resolve some of the corruption problems that they have within their countries, because you can forgive the debt and end up right back where you were in the first instance, because of the enormous problem that lies there in regard to corruption in some of these very fragile democracies that we have there.

Let me ask you this. If you had, hypothetically, a choice between a Gramm-Rudman cut on defense, which would of course cut back on a lot of spending in defense factories, et cetera, and it would be taking a hard hit on defense, or pass a consumption tax on gasoline, which do you think would be in the best interests of our economy?

Secretary BRADY. Congressman, I am on the President's negotiating committee where we are working with leaders in Congress now, and if you will permit me, I will keep my opinions to myself until we get through that process.

Mr. GUARINI. You see, when I opened up, I said you have been before many committees, and you have become very wise in the course of your discussions on some of these points, and I respect that.

Let me ask you, on estate taxes, we have an enormous build-up of wealth in the United States. Nothing is said about more estate taxes. There are some people that have accumulated over \$6 billion of wealth, more than any family could have. You know, that is creating a tremendous imbalance in our society, where you have a few families that can have \$10 billion, \$20 billion, \$50 billion in the course of time. You know, when you start—the eighth wonder of the world is when you have interest that continues to run on many of these businesses and investments.

Is there any consideration that is being given in regard to addressing the problem of the huge wealth that has been built up within a few families in our Nation? Would there be a better distribution of the assets of our Nation amongst all our people instead of just a few families having enormous strength and wealth, and power?

Secretary BRADY. Congressman, I can understand how this is a concern to a lot of people, but I guess my answer would be is, I do not know who is the judge as to who ought to be wealthy and who is not. Perhaps we ought to leave that to the system that we have got.

I think maybe the American people would be less happy if there was some force afoot that decided who is wealthy, and how wealthy you have to be before that organization comes in and says that is enough. So we think about it but we have not got it in any present plans.

Mr. GUARINI. I imagine that sooner or later we will be giving a lot of consideration to it, because just perpetuating this enormous wealth in just a few families is a concentration of power and privilege that will have a great impact on our society.

But that is a matter of philosophy and perhaps—
Secretary BRADY. I think so.

Mr. GUARINI [continuing]. A problem that has to be addressed, because we have reduced our estate taxes considerably over the last 10 years.

Secretary BRADY. Sure.

Mr. GUARINI. All right. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman. Welcome, Mr. Secretary. Just quickly on the world debt plan. I congratulate you for your initiative.

It was not at all clear that day, what the attitude of the President was. The press secretary, as you know, issued a statement.

I understand details are being worked out, but has the President agreed yet with the concept of a debt reduction effort, directly?

Secretary BRADY. Congressman Levin, I do not really understand what the confusion was. I gave a speech last Friday which was general in nature, and he had signed off on that speech. But there was some confusion, so last night, he issued a statement which said, roughly, the President fully supports the concept and processes aimed at debt reduction and economic growth which were set forth by Secretary Brady's speech at the Bretton Woods committee.

So I think if there was confusion on that before, there is not any now.

Mr. LEVIN. So when Mr. Fitzwater said the President has not made any final judgments about a new policy, he was talking about the details, and not that there needs to be a new initiative?

Secretary BRADY. You know, maybe the word "policy" was not the right word, but it was the details.

Mr. LEVIN. Good. On the capital gains, in your statement you say as an important part of this plan we have targeted the greatest relative benefits to those with incomes lower than \$20,000, if married, and \$10,000, if single.

The Joint Taxation Committee has put out its analysis, and I am not sure you have seen it yet or if you have had a chance to review it.

I think we need to debate this issue and I am anxious to participate in it. I just think it is important, at the same time, we not try to sell it for something it is not. The Joint Taxation Committee shows, in terms of the distribution of the aggregate tax change, that 1 percent would go to people with incomes of \$20,000 or less.

One-tenth of 1 percent to those with less than \$10,000, and nine-tenths of 1 percent with those between \$10,000 and \$20,000. So I do not really see how it is accurate, even as one is trying to sell a proposal, to say that it is an important part of the plan.

Secretary BRADY. Well, Congressman, I am—well, maybe I am guilty of trying to sell something. I was about to say I am not trying to sell something. But perhaps that is not the case.

I was not trying to say, in any sense, that the total amount of dollars that would be realized if this plan were adopted would accrue to the people under \$10,000. That is not true, with incomes under \$10,000 or family incomes under \$20,000.

We, in thinking about this plan, put it out to the estimators one day, and they came back with a figure that showed that it would at least give benefits to those people of \$300 million a year, and then that figure was even increased by the—was it the CBO, or the—

Joint Committee. Excuse me. So I am not trying to sell anything, but I thought it was a terrific idea, that if we can start—and I cannot visualize exactly who these people are.

Somebody said, well, you know, what kind of money do people have in this level? And I started to think maybe a few shares of a mutual fund, certainly their homes and things like that, and if we can give them a 100-percent benefit then—we all talk about equity—that, to me, is a very good idea.

If I said the “major share,” that is wrong wording. I cannot remember what I did say, but—

Mr. LEVIN. No, you said “an important part of the plan,” and then you used the word, or whoever wrote this, “we have targeted the greatest relative benefits.”

And it is true, but if \$300 million goes to one income grouping, and 20 to 50 times goes to another, I think to call the former an important part of the plan is an overstatement.

Sixty percent of the aggregate tax change goes to families in an income class, \$200,000 and above. That is what the Joint Taxation Committee report says.

Secretary BRADY. Yes. Well, I think that you have to look at it a little bit of a different way, too. Most of the tax being paid by the wealthier family here—I mean, this is a—it is a fact of the organization of where the ability to do this is, and the people in the middle and upper classes have the money, so they do pay the most tax.

But the biggest break is given to those in the lowest category. I thought it was a pretty good idea, to be honest with you, and if the words that are chosen there you think are not accurate, I would not argue about that.

I think it is a very, very good idea to give these people, whoever they are, whoever the estimators think they are, chances to be made the biggest benefactors, percentage-wise, if we do something in this area. You know, maybe the next time, the estimators, if something happens and we do adopt this, and it starts to work, we are putting money at that end of the income spectrum where we are trying to provide the most help.

I do not know. I mean, it just seemed to me like a good idea. I would be glad to say it is just a good idea, and not take the other words out.

Mr. LEVIN. Just when you say the biggest money goes to low income people, I just think it is important for everybody to understand that the biggest portion, by far, goes to the highest income—

Secretary BRADY. OK. Let me amend and say the biggest tax break.

Mr. LEVIN. Thank you.

Chairman ROSTENKOWSKI. Mr. Moody will inquire.

Mr. MOODY. Thank you. Mr. Secretary, we certainly enjoy working with you. I want to commend you for your initiatives on the debt, Third World debt, and of course for moving expeditiously on the FSLIC problem.

I would like to chat with you for a minute about the comparative disadvantage that S&L's may be at in the future relative to other depository institutions, namely, commercial banks.

Let's talk first, for a moment, about the sticker. As I am sure you are aware, a New York Times editorial of March 7 said that the Treasury Department first promised S&L's that they would have the same FDIC sticker on the door, that the banks would have since they are both going to be under FDIC.

In my State of Wisconsin, banks are already beginning to play up the fact there is going to be a difference between the FDIC and the FSLIC sticker. They are running ads in papers.

The savings and loans, which we all want to see preserved, feel that this sticker war may be a serious disadvantage for them.

Is this still an open question? Could they have the same sticker since they are both under FDIC?

Secretary BRADY. Congressman Moody, what we have done is sort of passed this question forward. In a sense we have, take two and hit to right. It was a matter of intense discussion between the S&L and the banking industry. We think it is going to take some more time to resolve that. Whether people would be satisfied with a sticker that said FDIC on top of it, and then has FSLIC underneath it, or savings and loan, federally chartered savings and loan in one case, and a commercial bank in another—we are not quite sure, and we think that that is something that is best left to the two parties that are trying to figure this out.

And if it passes forward to the FDIC, my feeling is that it is going to get settled, although it is a matter of strong feeling. You have said it exactly right.

Mr. MOODY. Right. Well, we both would agree—I hope—that there is no distinction between the degree of protection. The first \$100,000 is going to be protected, whatever the sticker. We do not want a sticker to make it look like there is a difference in the degree of protection to the depositor? Is that a fair statement?

Secretary BRADY. Good point.

Mr. MOODY. And I think that is the key, whatever the sticker says—it should not be drawn it looks like the depositor is more protected under one or the other.

Secretary BRADY. Right. Good point, and I think, you know, everybody ought to say that really almost at the beginning of any statement on the S&L, that the Federal guarantee is there and people do not have to worry about it.

Mr. MOODY. Right. Now moving for a minute to the premium and the possible deductions from the Federal Home Loan Bank Board. If the FSLIC fund reserves drop below a certain level, my understanding is that the premiums would go up and the Home Bank Board would have to put in more capital.

Under fairly reasonable scenarios, this would raise the basis points for savings and loan premiums by 56 points. Instead of about a 20 basis point differential, savings and loans would pay premiums more than 40 basis points higher than banks.

This is going to put the two depository institutions on a severely unlevel playing field if we want them both to survive. In fact, some material I have indicates that a rise of 57 basis points, which is triple the increase that banks face, exceeds, in many cases, the earnings of even healthy thrifts.

I certainly do not think we want to have a premium outcome which leads to the liquidation of otherwise healthy and well-man-

aged thrifts. The reason I raise this is that my State of Wisconsin has healthy, well-run, well-managed thrifts. They understand they are going to have to pay more. Their operating margins, Mr. Secretary, are in many cases healthy. But many would be wiped out by this kind of premium differential relative to the commercial banks.

I certainly think it would be appreciated if you could address this.

Secretary BRADY. Well, I think that the 35 basis points is the highest it ever gets to, but we do not really expect it to get there, and the Treasury is putting in \$9 billion per year to try to alleviate this problem.

So I do not think it is ever going to get there. It is permissive in the legislation, and I just do not think we will ever get to that point.

Mr. MOODY. All right. I appreciate your comment. I hope you are right, but it obviously raises some real fears among the well-managed segments of the S&L industry.

I understand that bank system capital and earnings assessed would raise that 35 up further on. So, if I am wrong, I would appreciate your later written comment. But my understanding is it could rise by 56.8 or almost 57 basis points for thrifts relative to the 14.2 basis point rise for commercial banks. That 3 to 1 difference could be serious. Any written comment would be much appreciated.

Secretary BRADY. Why don't we get back to you in print? My understanding is a little different but it would be better to do it that way, if that is OK.

Mr. MOODY. Thank you very much.

[The reply to Representative Moody's question from Secretary Brady follows:]

Annual premiums paid by commercial banks and thrifts could not exceed 35 one-hundredths of one percent under the administration's bill, H.R. 1278. (Section 208(1)(E)).

Although we do not anticipate any need to raise premiums to that level, we believe some ceiling on assessment rates is necessary.

Pursuant to an amendment to H.R. 1278 by Representative Barnard, the ceiling now appears in section 208(1)(C)(iv)(II) for Bank Insurance Fund members and in section 208(1)(D)(iv)(II) for Savings Association Insurance Fund members.

The thrift reform bill passed by the Senate on April 19, 1989, S. 774, provides for an annual assessment ceiling of 30 one-hundredths of one percent. (Section 208(4)(E)(III)).

Mr. MOODY. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. Mr. Secretary, I would like to ask you to go back to something you said to Mr. McGrath that I think was important. I could not agree with you more.

I really think what we must do in the next year to 18 months is work toward a strategy to make us more competitive in an international marketplace, and I think you were absolutely right on target in suggesting that some of the initiatives that I think you have come forward with thus far, puts us in that direction.

And one of those is certainly the capital gains tax. I am not a person that is simply opposed to lowering the capital gains, and I am most receptive to it. But I am somewhat perplexed, in looking back at the regs and the debate that went on when the Tax Code was reformed in 1986.

I was not here, I was not on the committee, but it is my understanding that one of the justifications for lowering those rates was to raise the capital gains tax.

Tell me what has changed. You said we are different now than we were then. We have got a different attitude now and we need to be more competitive, or we need to be competitive.

Secretary BRADY. Sir, I am not sure I quite get—

Mr. ANDREWS. Isn't that a little bit inconsistent, that in 1986, when we reform the Tax Code, one of the justifications for lowering the rates was to not keep the capital gains rate down there because we could pick up dollars that way. Wasn't that one of the arguments made by Treasury and the Reagan administration to justify lower rates?

Secretary BRADY. Well, Congressman, I was not here either, but the aim of our plan now is to create a differential so that we induce people to invest at longer term.

I fully take the point that there were different arguments in 1986 when we put in the tax act of that date, but in our view, the way we should be looking at it now is to try to create a differential for capital gains, and only make that available in the long-term, over a 3-year period, with the idea that we will get people in this country aimed at longer-term plans.

Now, in coming up with that idea, it was not looking backwards, and it may have some inconsistencies with the things that were said at that time. It was looking forward to be, start picking away at a problem of how do we get ourselves in the position to compete with others around the world who do think long-term?

I mean we are in an economic contest which will ultimately wind up—I am not trying to deliver a thesis on this—ultimately wind up in, if we do not watch it, a lower standard of living for our own people. So let's try and work at this problem as we can.

Mr. ANDREWS. I agree with you, and I do not want to belabor the point, but I do see some inconsistent arguments, that looking back at the record and reviewing the debate made primarily by the administration, by the Treasury Department in the Reagan administration, to justify those lower rates, and one of the rationales for doing what they did with capital gains and lowering the rates was to make us more competitive.

Let me just ask you to also address our savings rate. The Japanese save at a rate of about 23-24 percent; the West Europeans, what? 13-14 percent. Our rate of savings has been what, in the last 12 to 18 months? Under 3 percent?

Secretary BRADY. That is as accurate as I can give it to you.

Mr. ANDREWS. Mr. Secretary, if you could enumerate for us some of the specific things you think we must do, as a Nation, to turn this deplorable savings rate around and encourage savings.

Secretary BRADY. Well, Congressman, you have put your finger on what I think should be the focus of all of us in the next several years—is what do we do about our savings rate? Because if we do do something about it, then a lot of things will disappear which are now major concerns, such as the concern over foreign investment in the United States, and the like.

Also, the size of our deficit, which is big in terms of our savings, but with respect to the GNP is respectable with other economies

around the world. So the way I think about it is that we are pretty well pinched right now in terms of—because of the budget, and so there is not too much we can do except a few things like the capital gains tax that we put forward here right now.

But we ought to turn to that as quick as we get some leeway, and try to maybe come up with some incentives.

Mr. ANDREWS. Well, what would they be?

Secretary BRADY. Well, I cannot give them to you this morning, because to be dead honest with you, we have not spent a lot of time trying to be specific. But what I am told—maybe you have a different view—is that this problem is part mechanical, in the sense that the tax law would affect it, but also is the frame of mind that we have in this country.

We are, let's face it, a "fly now, pay later" society, and the other societies around the world, for reasons that are not clear to me, are not. So I think the attack probably ought to come in two areas.

When we can afford it, the revenue code, and some way of changing people's minds about how they should spend their money. I do not have the answer to that. It is a very, very deep problem.

Mr. ANDREWS. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Brady, thank you very much for joining us this morning. We appreciate the thoughts that you have shared with us.

I would just like to conclude with one observation. For extending expiring tax provisions alone, many of which currently expire on the 31st day of 1989, Mr. Secretary, there is a cost of over \$3 billion in fiscal year 1990. That is just an extension of the expiring provisions.

Now we are talking about how we are going to raise revenue, and what we are going to do, and I agree with the President—I would like to see a kinder and gentler America—but I think we have got to pay for it, Mr. Secretary.

And the problems that I see with the budget, as it has been presented, are similar to those that some of the members on this committee have alluded to.

I just do not know that we are going to be able to impress our friends throughout the world with respect to how we are going to attack this deficit, unless we seriously start talking about some revenues.

Now I know that that is not acceptable with this administration, but I am hoping that over a period of time there can be a meeting of the minds and that we can become very serious about just how we are going to attack the problem that is ours. It is not the President's. It is not mine. It is ours. And I want you to know that I appreciate the time that you have spent with us this morning. Thank you very much.

Secretary BRADY. Thank you, Mr. Chairman.

[Whereupon, at 12:12 p.m., the committee was adjourned, subject to the call of the Chair.]

[Submissions for the record follow:]

HEARING ON THE BUDGET IMPLICATIONS AND
CURRENT TAX RULES RELATING TO TROUBLED
SAVINGS AND LOAN INSTITUTIONS

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

Statement of the Section of Taxation
of the American Bar Association

This statement reflects the views of the Section of Taxation of the American Bar Association. It has not been approved by the American Bar Association and accordingly should not be construed as representing the position of the Association.

Recommendations

The Section recommends that any extension of the current tax law provisions dealing with aid to and the reorganization of troubled savings and loan associations (and commercial banks) be evaluated substantively in terms of (1) whether those provisions have achieved the purposes for which they were originally enacted in 1981 and extended in 1988, (2) whether they are economically efficient as compared with other non-tax alternatives, and (3) whether and to what extent the beneficial effects of their extension outweighs any inconsistency with the policies underlying the Tax Reform Act of 1986. For many practical reasons, the Section also recommends that a decision either to extend or permit the termination of these provisions be made and acted upon early in the legislative year.

Similar criteria should be applied to proposals for new provisions intended to contribute toward resolution of the savings and loan problem. In other words, these provisions should be considered in terms of whether they work, how much they cost, and who gets the benefit.

Finally, we believe that it is appropriate for the committee to postpone an overall review of other provisions of current law that may be viewed as providing special tax benefits to savings and loan institutions pending the resolution of current initiatives concerning the supervision and regulation of thrift institutions and the insurance of deposits in such institutions. Many of the provisions of current law of special application to thrift institutions reflect to some degree the historic segmentation of the financial services market into distinct service sectors from a regulatory and powers and services perspective. If the Congress enacts legislation that reduces or eliminates some of the distinctions between various financial services providers, it would be appropriate for the committee to review current law at that time to determine whether a continuation of the different tax rules applicable to different sectors of the financial service is appropriate.

Background

The troubled thrift reorganization provisions, including the exclusion of FSLIC payments from income, were enacted as part of the Economic Recovery Tax Act of 1981 to respond to economic conditions, including high interest rates, that adversely affected the thrift industry. These provisions, facilitating the transfer of tax attributes, primarily the net operating loss carryover, in tax-free reorganizations and exempting from tax amounts received as assistance payments from the Federal Savings and Loan Insurance Corporation (FSLIC), were intended to facilitate the providing of financial assistance by the FSLIC and the merging of financially troubled thrift institutions into stronger institutions.

The Tax Reform Act of 1986 repealed the special rules for troubled thrift reorganizations and the tax-exempt status of FSLIC assistance payments effective for taxable years beginning after 1988. The reasons given for the repeal were that the preferential tax treatment afforded by these provisions was inconsistent with the policies of normal tax rules and was unfair because it provided beneficial treatment to a selected class of beneficiaries.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) postponed repeal of these provisions for one year. It also expanded the application of the tax free treatment of FSLIC assistance payments to payments by the FDIC but limited the benefit by providing for a 50 percent reduction in certain tax attributes associated with assisted takeovers. No explicit rationale was given for the extension.

Discussion

The tax provisions relating to the thrift crisis that are the most time sensitive are the troubled institution reorganization provisions first enacted in 1981 that were modified and extended through the end of the current taxable year by TAMRA.

Early Decision Needed on Extension

As the Congress has increasingly adopted tax provisions of a temporary nature the problem of extending expiring provisions has become a regular annual concern for the committee and for taxpayers. In such cases sound tax administration and sound tax policy are best served by reaching and acting on a decision on the extension of expiring provisions before their expiration.

In the present context that may be particularly important for the following reasons: First, to the extent that it is determined that the availability of the troubled institution reorganization provisions assists materially in dealing with the thrift crisis, the possibility of non-extension or the prospect of revival after expiration may affect adversely the ability of the supervisory agencies to negotiate and implement transactions as the expiration date approaches. Uncertainty about the continued availability of these provisions is likely to have an effect on the terms of the

agreements entered into in connection with these transactions, diminishing the economic efficiency of the provisions or resulting in unintended windfall benefits as the time of expiration approaches.

Second, as the expiration date approaches the urgency of concluding agreements before the deadline may result in transactions being entered into which would not have been entered into under less pressured circumstances, or in the terms of the agreements being more or less favorable than would otherwise be the case.

While an early and firm decision not to extend the provisions could trigger a rush to conclude agreements before the provisions expire as December 31st approaches, it would enable acquiring institutions and the supervisory agencies to negotiate the terms of acquisitions in an atmosphere of greater certainty. Similarly, a decision to extend, if made early, would allow regulatory agencies to use these provisions to best advantage.

Criteria for Extension

In determining whether to extend the expiring provisions, we believe the committee should examine not only the economic efficiency of providing incentives through the Internal Revenue Code, as compared to other, non-tax alternatives, but also evaluate the impact of extension of these special provisions on the tax system and on the principles underlying enactment of the Tax Reform Act of 1986.

The decision of the Congress, contemporaneous with enactment of the Tax Reform Act of 1986, to repeal these provisions should not be taken as conclusive evidence that their continuation is completely inconsistent with the principles embodied in that legislation. The 1986 Act was a large and complex bill and many of its provisions necessarily reflect compromises reached at the time among competing priorities and policies. Differences of opinion continue to exist over whether the general net operating loss carryover rules reach the most appropriate tax policy result. In this connection, we believe it would be appropriate for the committee to look not only at the impact of the troubled financial institution reorganization and assistance provisions on the ability of the FSLIC and the FDIC to assist in the acquisition of troubled financial institutions by stronger institutions, but also at the use of the tax benefits conferred by these provisions. Additional or different limitations similar to those enacted by TAMRA may be appropriate.

In conducting its review, the committee should bear in mind that it was, in many respects, the cumulative effect of years of enactment of relatively narrowly focused or targeted provisions intended to deal with specific situations that gave rise to perceptions of unfairness and special privilege that were part of the impetus for the broad-based tax reform proposals which resulted in the enactment of the Tax Reform Act of 1986.

As the extension of these provisions must be considered in the context of the current federal budget deficit and laws enacted to reduce the deficit, consideration must also be

given to any diminution in tax revenue associated with their extension.

New Proposals

The same criteria should be applied to other proposals for changes in the tax law intended to aid in dealing with the thrift crisis. Particular attention should be paid, in the case of new proposals, to the desirability of adding additional provisions to the tax law which create exceptions to general rules.

Other Provisions

The announcement of the hearings requests testimony not only on the expiring provisions but also more generally on provisions which provide special assistance to savings and loan institutions. We believe that it would be appropriate for the committee to defer any full scale review of the taxation of financial institutions, which should be a prerequisite for analysis of such other provisions, at least until after the Congress has acted on the Administrations's proposals concerning the regulation and supervision of savings and loan institutions.

STATEMENT OF KENNETH L. ROBINSON, PRESIDENT
NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. Chairman and distinguished members of the Committee, the National Association of Federal Credit Unions (NAFCU) appreciates this opportunity to comment for the record as part of the Ways and Means hearings on the budget implications and current tax rules relating to troubled savings and loan institutions. My name is Kenneth L. Robinson, I am President of the National Association of Federal Credit Unions. NAFCU is the only national organization exclusively representing the interests of credit unions chartered by the federal government, all of which are required by law to be federally insured. There are approximately 14,113 federally insured credit unions nationwide with over 51.8 million members.

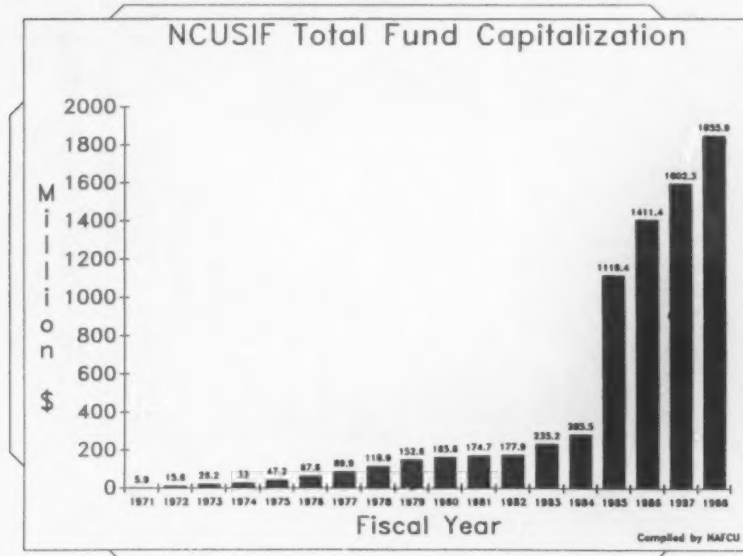
NAFCU member credit unions are deeply concerned by Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (H.R. 1278) as proposed by the Administration. This legislation would require all 9,275 federal credit unions and 4,838 state chartered, federally insured credit unions to expense over eight years the one percent of insured shares now held in deposit by the National Credit Union Share Insurance Fund (NCUSIF). As a result, title to these funds -- which in fact are an asset of credit unions available for immediate use by the National Credit Union Share Insurance Fund if necessary -- would transfer from credit unions and their members to the federal government.

This proposed change has been characterized as a technical, noncontroversial accounting adjustment which would strengthen the National Credit Union Share Insurance Fund. This generalization is an extremely inaccurate assessment of the impact this change would have upon credit unions and the NCUSIF. The fact is this proposal is neither noncontroversial nor will it strengthen the NCUSIF. Indeed, the proposal would weaken credit union share insurance. This proposal would fail to bring a single new dollar to Washington; to the contrary, it would bring less money into the NCUSIF in the future than is currently provided. Furthermore, it represents a hasty, unilateral, and ill-advised rescission of one of the key provisions of the carefully-crafted NCUSIF recapitalization agreement between Congress, the Administration, and the credit union community. Such a change is unwise, unwarranted and unnecessary. The NCUSIF is now and consistently has been since its voluntary recapitalization by credit unions in 1985 the healthiest of the three federal deposit insurers. For all these reasons, the nation's federally insured credit unions oppose this inclusion of credit unions in the Administration's proposed legislation, and urge you to do likewise.

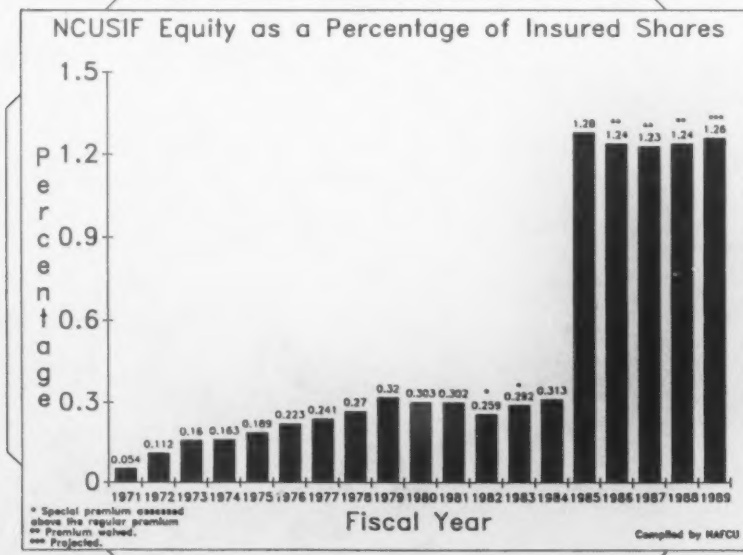
The History of Federal Credit Union Share Insurance

To understand fully its negative impact, the proposal contained in H.R. 1278 must be examined in the historical context of credit union share insurance. Unlike its counterparts in the bank and savings and loan industries, the NCUSIF was not established during the Depression era. Rather, it was not until the late 1960's that federal credit unions sought the establishment of a federal deposit insurance fund. These efforts -- which I should note served as the genesis of the National Association of Federal Credit Unions -- were rewarded by Congress in 1970 when it enacted legislation authorizing the establishment of the NCUSIF. To further distinguish the NCUSIF from its counterparts, not a single taxpayer dollar was ever provided to assist credit unions establish the NCUSIF. By comparison, FDIC received \$289 million and the FSLIC received \$100 million in seed money from the U.S. Treasury. These amounts would total over \$3.4 billion in 1989 dollars. Further, credit unions have neither sought nor ever needed taxpayer funds to operate or recapitalize the NCUSIF.

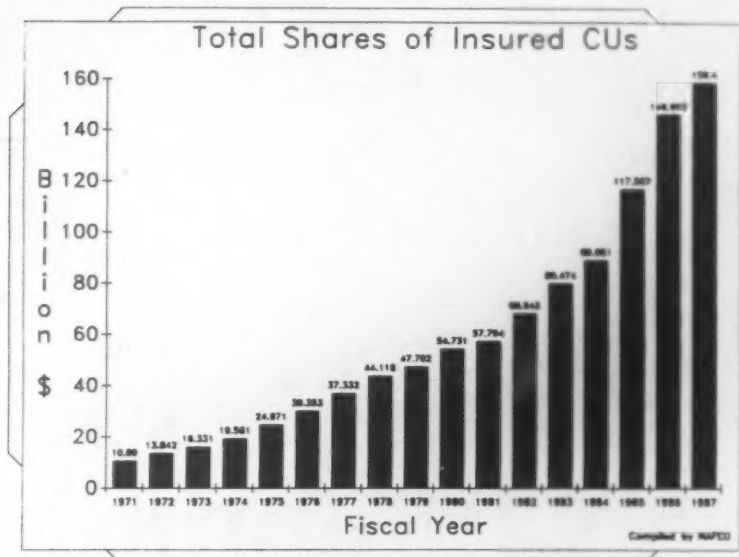
Over the course of the NCUSIF's first decade and a half, it became increasingly obvious that a premium-based insurance system was inappropriate for credit unions because such a system was incapable of keeping pace with the rapid growth experienced at insured institutions. From 1971 to 1984, the NCUSIF grew from just under \$6 million to \$285 million -- an increase of a remarkable 4,831 percent, as indicated by the chart below.



During this same period, the NCUSIF's ratio of equity to insured shares increased nearly six-fold to 0.313 percent.



Yet, in spite of this notable success, this growth failed to capitalize the NCUSIF to a level acceptable to the credit union community as was originally expected. This was because insured shares during this period grew by an unprecedented 823 percent from \$10.9 billion to \$89.7 billion.



The 1984 NCUSIF Recapitalization

It is for this reason that in 1984 the credit union community presented to Congress a proposal to replace the exclusively premium-based insurance system with a restructured, modernized, "pay-as-you-go" system. The 1984 NCUSIF recapitalization plan -- which was conceived by the credit union community, presented to Congress by the credit union community and consisted solely of credit union funds -- very much reflects the cooperative and mutual nature of the institutions it serves to insure.

That the NCUSIF is structured in a fashion different from the other federal deposit insurers is not inappropriate. The current Chairman of the Senate Banking Committee, Sen. Don Riegle (D-MI), in rising on the floor of the Senate on May 18, 1984 to lend his support to the NCUSIF recapitalization legislation (S. 2522) which he characterized as "a reasonable and well thought out approach to the needs of credit unions," he explained it best when he said,

[T]hose of us who serve on the Banking Committee appreciate those unique characteristics of credit unions which distinguish them from other institutions in the financial services industry. The National Credit Union Share Insurance Fund is one example of that distinctive difference.

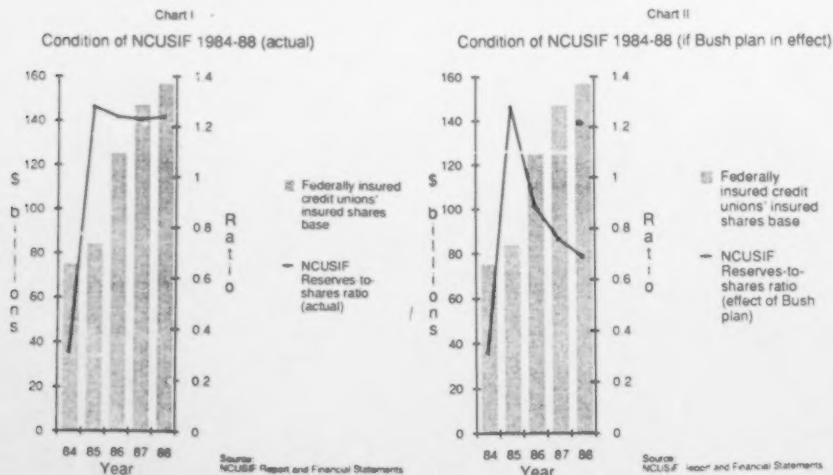
The 1984 NCUSIF recapitalization plan provided that federally-insured credit unions were to maintain deposits equal to one percent of their total insured shares with the NCUSIF. Furthermore, this carefully-crafted package which was agreed to

by Congress, the Administration, and credit unions provided that insured credit unions could keep those funds on their books as assets, while the NCUSIF keeps the interest earned off these funds. The plan, which was enacted by Congress and signed into law by President Reagan on July 18, 1984, has two provisions related to credit unions keeping those funds as assets which are absolutely crucial to the continued safety and soundness of the funds. Both would be eliminated to the detriment of the NCUSIF by the legislation under consideration today.

The Impact of the Administration's Plan

The first is that as a credit union grows, it is required to adjust annually the funds held on deposit at NCUSIF to reflect that growth. For example, if a credit union grows by 10 percent in one year, the funds which the credit union maintains at NCUSIF must likewise be increased by 10 percent at the end of that calendar year. This aspect of the 1984 recapitalization plan was designed to guarantee that NCUSIF would grow at the same rate as the credit unions it insures, which was the fund's most serious deficiency prior to 1985. As previously explained, although the NCUSIF's funds grew at a steady pace throughout the 1970's and into the 1980's, its equity ratio had difficulty rising above 0.30 percent because of the rapid growth of insured shares. This feature, which would be eradicated under Title XI of H.R. 1278, remains crucial today.

Notwithstanding assertions by the Administration to the contrary, the change proposed in Title XI would not strengthen the NCUSIF but, rather, would weaken it for just this reason. NAFCU projects that had the plan, as described by Secretary Brady, been in effect in the five-year period of 1984-1988, the NCUSIF reserves-to-share ratio -- which has stood between 1.23 and 1.30 percent since 1985 -- would have steadily declined to 0.64 percent because of the loss of the annual one percent adjustment. Chart I below shows the result of the 1984 NCUSIF recapitalization. Since then the NCUSIF has maintained a relatively constant level of reserves to shares insured (the solid line reflects the ratio of reserves to insured shares; the vertical bar at the right measures the ratio of insurance fund reserves to total shares). Chart II shows the result of the Bush Administration's plan on the NCUSIF had it been in effect since 1985. The ratio of reserves to shares insured, under this plan, would have consistently declined during the period 1985-88 (as illustrated by the solid line, reading from left to right) to a level roughly half of what it actually is today. This is the result of eliminating the annual adjustment of credit union funds held on deposit at NCUSIF to reflect credit union growth while the insured share base increased by over 75 percent, as manifested by the gray bars on both Charts I and II.



Thus, from this perspective, Title XI defies the common wisdom that a fund with more money in it is better off than a fund with less! The effect of the Administration's proposal is that it would make the NCUSIF unacceptably and inexcusably vulnerable to credit union growth.

The second effect of requiring credit unions to maintain a deposit at the NCUSIF equal to one percent of total insured shares is the implicit guarantee that, even in the worst case scenario, NCUSIF will be able to maintain a reserves-to-share ratio of at least 1.00 percent. This is true because NCUA currently has the statutory authority -- in the improbable event that it ever becomes necessary -- not only to employ credit union assets under its control and maintained at the NCUSIF but, more importantly, to require insured credit unions to replenish the fund as well. If NCUSIF's ratio of reserves to insured funds should ever decrease to a level below 1.00 percent, credit unions would be required not only to write off those expended funds, but also restore the fund to a 1.00 percent level at that time.

Thus, the current system employed by NCUSIF not only insures that a FSLIC-type crisis will not occur at our nation's credit unions, but it further guarantees that the NCUSIF will not suffer a decline in capital to the extent that the FDIC is currently experiencing. However, it is very important to bring to your attention that the likelihood of NCUSIF's reserves ratio dropping to a level as low as 1.00 percent is extremely remote.

NCUSIF: The Safest and Soundest of the Federal Deposit Insurers

Mr. Chairman, since its voluntary recapitalization by credit unions, the NCUSIF has been and is now the healthiest of the three federal insurance funds. To guarantee its continued success, the NCUSIF has three solid barriers to protect against NCUSIF's reserves to insured shares ratio dropping below 1.00 percent. The first barrier is the interest income which is earned off of the deposits held by the fund. In 1988, this amount equalled \$133 million, an amount 3.3 times more than NCUSIF's annual loss average over the last five years of \$40.2 million and 1.7 times more than NCUSIF's highest loss ever of \$77 million in 1982, the worst economic year since the Great Depression. In 1989, NCUSIF interest income is expected to increase to perhaps as much as \$160 million as a result of higher interest rates.

At this point, I would like to digress for a moment to address a misconception which some would have us accept as a truth -- that credit unions do not pay a dime for federal insurance. Nothing could be further from the truth. Not only did credit unions volunteer to keep one-percent of shares in Washington, D.C. -- an action which the president of the American Bankers Association said his members would vigorously object to if ever imposed upon banks -- but credit unions earn no interest on these funds whatsoever. If a credit union could earn more than 8 1/3 percent interest on these funds, which is today not a difficult undertaking, then a credit union in effect is paying a premium in excess of 1/12 of one percent for federal insurance.

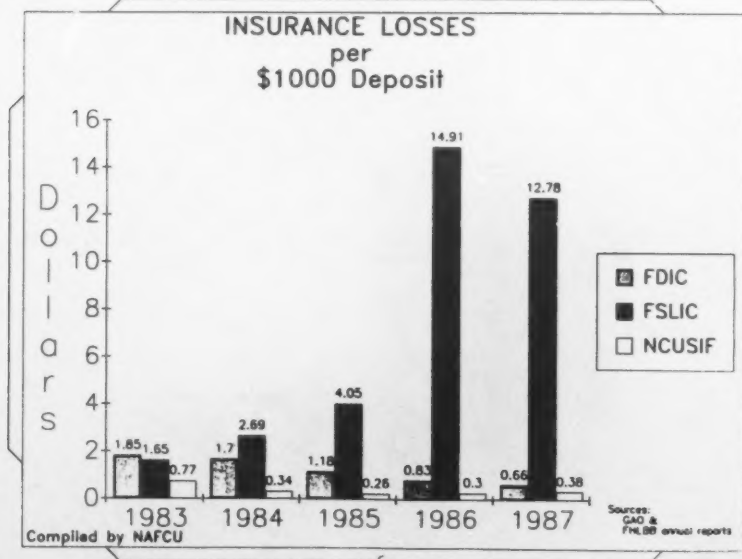
There are those who, for reasons I cannot explain, ridicule the deposits in the NCUSIF as "funny money" or accuse credit unions of legerdemain in accounting for keeping these deposits on their books as an asset. Credit unions and the NCUSIF use generally accepted accounting practices, and maintaining these deposits on credit union books as an asset is entirely appropriate according to those accounting principles. Further, I can assure this committee that there was nothing funny about the \$100 million dollars sent to the NCUSIF in January of this year by credit unions to bring their deposits up to the 1 percent threshold. The same holds true for the other \$1.5 billion sent

by credit unions to NCUSIF from 1985-1988. These are real dollars, not funny dollars, and each one of them contributes to decreasing the federal budget deficit.

The second barrier protecting NCUSIF is the NCUA's current statutory authority to assess and collect a premium equal to 1/12 of one percent of insured shares. Although this action has never been and is unlikely ever to be necessary, this premium would raise at least an additional \$130 million, thereby nearly doubling the NCUSIF's income in any given year.

These two measures combined provide for more than sufficient coverage for any reasonably foreseeable loss to the NCUSIF. For example, these two measures would generate \$275 million in 1989, an amount 3.6 times larger than the highest annual loss ever experienced by the NCUSIF in the depths of the 1982 recession, and 6.9 times greater than the average five year annual loss. It is important to note that even under such unprecedented circumstances, the NCUSIF's reserves-to-shares ratio would still stand at 1.25 percent, a level which FDIC someday aspires to attain. In order for NCUSIF's reserves-to-share ratio to drop to 1.00 percent, an additional \$391 million in losses would be required to occur to hurdle the fund's third protective barrier -- the NCUSIF's total retained earnings. In 1989, for example, total NCUSIF losses would have to exceed \$667 million -- or 8.6 times NCUSIF's worst annual loss ever, or 16.6 times the five year annual loss -- in order for the fund's reserve-to-share ratio to decline to 1.00 percent. To put it in even more graphic terms, in a single year the National Credit Union Share Insurance Fund would have to incur losses of \$170.3 million greater than its total aggregate losses over its entire history from 1970 to today before the reserves-to-share ratio would dip below 1.00 percent.

These circumstances are, needless to say, highly unlikely. However, it is crucial to point out that NCUSIF already has a mechanism in place to guarantee that the fund would remain at 1.00 percent, compared to the current FDIC level of 0.83 percent. By contrast, if FDIC ever experienced losses of 8.6 times its 1987 loss or 16.6 times its 1983-1987 average, the fund would experience a deficit of between \$8.1 and \$13.6 billion! It is also important to note that while a record number of banks and savings and loans were closed by FDIC and FSLIC in 1988, NCUSIF also set a record for failed institutions -- a record low! Furthermore, as the chart below illustrates, the NCUSIF's loss ratio is historically much lower than either FDIC's or FSLIC's. This is because credit union assets are considerably less risky than those of their counterparts.



The point of these observations is to indicate that safeguards to protect the NCUSIF are more than sufficient, particularly when compared to the other federal deposit insurers. We are convinced that additional safeguards are not necessary at the current time nor will they be needed at anytime in the foreseeable future. However, even if there was a need to strengthen further the NCUSIF, the proposal contained in Title XI of H.R. 1278 would not be desirable because, rather than improve the fund, it would inflict considerable harm to the continued safety and soundness of the NCUSIF.

NAFCU's Position

Mr. Chairman, the Administration's legislation addressing the nation's deposit insurance system has been coined by some as the "Never Let It Ever Happen Again Act of 1989." NAFCU is heartened to see steps being taken to resolve problems in the financial industry. But converting credit union deposits to government ownership and adding an expense burden to credit unions for eight years all in the name of efficiency, ease or "comparable accounting" -- while leaving the NCUSIF in a weakened position for the future -- just doesn't make sense. Title XI of H.R. 1278 has no connection whatsoever with either the FDIC or FSLIC, or the serious depletions these funds have experienced. Contrary to the intent of this legislation, Title XI would only seriously hurt the insurance system Congress established just five years ago and raise the distinct possibility of Congress being required to redress this harm in the near future.

Title XI is not only ill-advised and injurious, but it is ironic as well. Title X of H.R. 1278 mandates a study to investigate, among other things, how incentives for market discipline might be developed to minimize insurance fund losses, while the next title of H.R. 1278 would eliminate the only successful system which already has in place precisely such incentives. If it is the intent of the Administration to seek uniformity, the nation's credit union community might suggest that NCUSIF's 1984 capitalization should be the model which FSLIC and FDIC should follow, not the other way around. Such action would be consistent with the recommendation contained in the GAO's recently released report, Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47). Specifically, the GAO states in that report, "We envision that recapitalization of the good...fund would be similar to the NCUSIF recapitalization under the Federal Credit Union Act amendment to the Omnibus Deficit Reduction Act of 1984." [See Appendix A]

We suggest this course of action for several reasons. First, the NCUSIF is the only fund which not only follows generally accepted accounting principles, but also makes a public monthly report as to its financial status and is audited annually by an independent outside accounting firm.

Second, the NCUSIF is the only fund that guarantees a capital level of 1.00 percent. This model -- if adopted by the other funds -- would most expediently return capitalization levels of FDIC and FSLIC to 1.25 percent.

Third, the NCUSIF is the only fund which has the ability to keep pace with the growth of insured savings. Further, the NCUSIF is the only fund where the financing burden is spread equitably among insured institutions, with those experiencing more rapid growth contributing proportionally greater sums to the insurance fund.

Fourth, the NCUSIF is the only fund which is designed to deal with both normal losses and catastrophic losses.

Lastly, the NCUSIF is the only fund that provides insured institutions with a strong market incentive to minimize insurance losses. Credit unions have a stake in minimizing their losses and the losses of other federally insured credit unions because excessive losses would result in not only more premiums, but restoration of their depleted NCUSIF deposits as well. This incentive should not be eliminated in the name of uniform accounting, particularly at the cost of the continued solvency of the NCUSIF.

Additional Provisions of H.R. 1278

Mr. Chairman, there are two other areas addressed in H.R. 1278 that I would like to focus upon briefly. The first has to do with enhanced enforcement authority for the National Credit Union Administration; the second has to do with the ability of NCUA to recruit and retain qualified examiners and staff.

NAFCU has been and remains committed to a regulatory system for credit unions which, to the best extent possible, guarantees the safety and soundness of all credit unions. As I have discussed at length, a sound and solid National Credit Union Share Insurance Fund is essential to such a plan. But the insurance fund can be most effective when the National Credit Union Administration Board has available to it tools necessary to engage in the proper supervision, regulation and examination of insured credit unions. Accordingly, we are generally supportive of the enhanced enforcement authority provided NCUA by this legislation. There are, however, specific provisions contained in Subtitle C of Title IX which we believe should be reviewed and revised. Specifically, we question both the need and the desirability of providing NCUA with the discretionary authority to assess a penalty of up to \$1 million per day on insured credit unions for violation of final orders. Sanctions clearly must be sufficient to induce compliance; however, we believe that an increase of the existing penalty from \$1,000 to \$25,000 for each day a violation continues should provide more than ample inducement to provide compliance. Penalties in the magnitude of \$1 million a day are clearly inappropriate for credit unions, particularly in light of the fact that the average credit union is only \$12 million in asset size.

As the members of this committee well understand, the National Credit Union Share Insurance Fund and its parent, the National Credit Union Administration, are both funded exclusively by the credit unions they insure and regulate. Not a single tax dollar has ever been used to assist in the funding or operations of either the NCUSIF or the NCUA. Against this backdrop, we believe the civil and criminal forfeiture provisions contained in Section 917 should be revised. The forfeiture provisions as presently constituted in Section 917 would allow any property taken or seized under forfeiture provisions to revert to the federal government, be liquidated, and funds generated by such liquidation deposited in the General Fund of the Treasury. Admittedly, such funds may be made available upon the order of the appropriate financial regulator to the financial institution which has a meritorious claim to those funds. Nevertheless, it seems only appropriate that such restitution ought be made to the institution as a matter of right and the cost by the financial regulatory agency should be repaid from the fruits of the forfeiture.

In regard to NCUA's ability to recruit and retain qualified examiners and support staff: the National Association of Federal Credit Unions strongly recommends to Congress that it extend to the National Credit Union Administration those provisions contained in H.R. 1278 which, if enacted into law, would permit the Comptroller of the Currency to establish compensation levels for employees of that office, provided such compensation shall be

generally comparable with that of the other federal financial regulators. The failure to give NCUA such comparable authority could have a serious negative impact on NCUA's recruitment potential, as well as a crippling effect upon staff morale and the ability to retain competent staff. I would ask the committee to view favorably this recommendation, recognizing once again that no tax dollars are used in the compensation of NCUA employees. Rather, such funds are derived by the agency from the credit unions it regulates, supervises and insures. Therefore, favorable action by this committee would be deemed appropriate, particularly since such action would not have any negative budgetary impact.

Conclusion

Chairman Rostenkowski and distinguished members of this committee, there is an old saying that if something isn't broke, then don't fix it. Today, our message is a corollary to that rule: five years ago with your help and support we fixed the NCUSIF. In this year of 1989, let's not break it.

Thank you.

Appendix A

Excerpt from a GAO report entitled "Troubled Financial Institutions, Solutions to the Thrift Industry Problem."

Appendix VI

Recapitalization of the National Credit Union Share Insurance Fund

Our report discusses a good company/bad company merger of FSLIC and FDIC. We envision that recapitalization of the good company fund would be similar to the NCUSIF recapitalization under the Federal Credit Union Act amendment to the Omnibus Deficit Reductions Act of 1984 (Public Law 98-369). This appendix explains the key provisions of the NCUSIF arrangement and discusses briefly how the NCUSIF plan has worked thus far.

The NCUSIF Recapitalization

During the 1970s NCUSIF was funded primarily by annual premium assessments, from which it had built capital and reserves to 0.3 percent of insured shares in 1979—a level below the 1 percent level prescribed in the Federal Credit Union Act. Beginning in the late 1970s, NCUSIF faced financial problems because economic fluctuations, poor investments, and stiffer competition had caused a number of credit unions to fail. Reserve levels fell and remained below 0.3 percent through 1983 in spite of a special premium assessment which increased assessment income by 67 percent in 1982 and by 100 percent in 1983.

The Federal Credit Union Act amendment to the Omnibus Deficit Reduction Act of 1984 provided that a credit union applying for federal insurance would pay and maintain a deposit of 1 percent of the value of insured shares (deposits) with the insurance fund. The act also provided that the normal operating level for NCUA reserves would be determined by the NCUA Board. The Board has thus far set it at the maximum level prescribed in the act—1.3 percent of insured deposits. The act also provided that credit unions would pay annual premiums of 1/12 of 1 percent if required by the NCUA Board to maintain the normal operating level after payment of insurance expenses. If reserves exceed the normal operating level, the Board could waive the subsequent insurance premium, rebate the previous premium, or distribute the excess amount to the credit unions as a dividend.

The NCUA plan had two key features. First, the 1-percent deposit is carried on each credit union's books as an asset and is fully refundable to the institution if insurance coverage is terminated, other insurance coverage is obtained, or if NCUA operations are transferred from NCUA. The deposit is not refunded if the institution is liquidated due to insolvency or bankruptcy. Like any asset, the deposit can be carried at full value so long as its value is not materially impaired. Therefore, so long as the insurance fund is not experiencing losses so large that it must use the 1-percent deposit to pay expenses, the cost to the credit unions of financing the insurance fund is equal to the net effect of the following items:

Page 136

GAO GGD-89-47 Solutions to Thrift Problems

foregone income that could have been earned by investing the 1-percent deposit in other ways, the premiums avoided, and any dividend rebated by the insurance fund.

The second key feature of the NCUA plan is that the contribution by the credit unions was considered a revenue item for the fund and a revenue item for federal budget purposes primarily because all NCUA funds are maintained in an account with Treasury. Thus, when NCUA was recapitalized, the initial deposit resulted in a credit of \$844 million which was treated as revenue, thereby reducing the federal deficit and offsetting the deficit-increasing effect of expenditures on case resolutions.

Experience Under the Recapitalization Plan

The NCUA recapitalization seems to have worked well. NCUA reached its target operating level in the first year while simultaneously acting to resolve problem cases. The credit unions have not had to pay an annual insurance premium since the recapitalization—avoiding \$387 million in premiums over the 1985-1988 period. (A 1-year waiver equals about an 8.3 percent dividend on the credit unions' 1-percent contribution.) The credit unions' investment in NCUA has not been at risk, so credit unions have been able to carry their contribution as a fully valued investment asset. From a federal budget perspective, NCUA recapitalization increased the government's net receipts over \$800 million in 1985 and about \$100 million in 1986.

The credit union actual payment was \$760 million. The remainder of the \$844 million high-watert the value of the premium waiver and a dividend for 1985 which were credited as part of the initial contribution.

Page 137

GAO GGD-89-47 Solutions to Thrift Problems